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Economic governance of the Euro zone: A revision of *Notre Europe*'s contributions to the debate (1997-2005)

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Introduction

The issue of economic governance of the Euro zone has been a matter for academic discussion since the Delors report of 1989. At the political level, the debate has had its ups and downs. It was particularly vivid during the negotiation of the Maastricht Treaty (1991), during the years preceding the entrance into the third stage of EMU (1997-1998), and some years after the creation of the EMU (1999-2004), when various episodes put into evidence the vulnerabilities and limitations of existing institutional arrangements. From 2005 onwards, the interest on the subject declined. The relative economic prosperity of those years and the reform of the Stability and Growth Pact, which integrated many of the criticisms done to the Pact during the early 2000s, led many people believe that the problems of EMU governance were finally fixed. Unfortunately, the crisis has bluntly proved how erroneous it was this belief, opening again a debate on how to govern the EMU economy.

While *Notre Europe* is intensely participating in current debates on EMU governance, it also participated in the second (1997-1998) and third rounds of the debate (1999-2004) through the publication of various studies and the organisation of some seminars. In line with Jacques Delors' position on this topic, NE contributions of those years stressed the need for better and more economic policy coordination in the Euro-zone, by pointing out the risks of non-coordination and/or the insufficiencies of current mechanisms of economic governance. Diagnostic and analysis was in certain cases accompanied by prescription (i.e., the formulation of specific recommendations on how to improve existing mechanisms of policy co-ordination in the Euro zone).

As economic and political circumstances have changed, concerns related to the non-coordination have varied, and so the arguments and policy recommendations put forward in NE documents. In particular, there is a clear distinction between the documents published before the creation of the EMU (1999) and those that appeared afterwards. While the first discuss the risks of non-coordination from a rather theoretical perspective and provide generic recommendations on how to secure an appropriate system of economic governance in the EMU, the second are based on empirical evidence on the problems of macro-economic stability and growth in the EMU zone and on the limitations of existing institutional arrangements for policy co-ordination to solve these problems.

The prelude: Ideas on economic governance set forth in the Delors Report (1989) and during the 1991 Treaty negotiations

Written in 1989, the Delors Report provided clear recommendations to advance to the construction of the European and Monetary Union. The report considered that some degree of convergence of economic policies was something indispensable in a single currency in order “to avoid imbalances which could cause economic stains”. But the creation of an economic union was also viewed as a goal in itself. Indeed, the Report conceived the EMU as “the final result of a process of progressive economic integration in Europe”. In consequence, it defined economic and monetary union as “two integral parts of a single whole” and recommended implementing them in parallel

Economic union had to be achieved through a combination of Community actions (actions to develop the single market, competition policy and common policies aimed at promoting structural change and regional development) and the coordination of national macro-economic policies.

With respect to the latter, the report recommended coordinating all areas of national economic management affecting aggregate demand, prices and costs of production. It paid however particular attention to the co-ordination of fiscal policies. The latter was considered essential for two purposes: to ensure national governments’ fiscal discipline (and therefore monetary stability) and to allow the Community to establish a coherent fiscal/monetary mix (a pre-condition for conducting Keynesian-like macro-economic growth policies). Apart from that, member states were expected to work together in the formulation of the Community exchange rate policy (in cooperation with the monetary authority) and in the definition of the Community position in international policy coordination processes. The Report also stressed that, “with due respect to the independent status of the ESCB (…) appropriate consultations procedures would have to be set up to allow for effective coordination between budgetary and monetary policy”.

With regard to the institutional procedures to ensure this co-ordination, the Report alerted on the need to “strike a balance between reliance on binding rules (..) and discretionary coordination adapted to particular situations”. It considered particularly important to ensure the co-ordination of fiscal policies by:

a) establishing binding rules on the size and financing of national deficits
b) setting up of a procedure to define the overall stance of fiscal policy over the medium term, “including the size and the financing of the aggregate budgetary balance, comprising both the national and the Community positions”.

While the Maastricht Treaty took up the fundamental conclusions of the Delors Report, the balance between the monetary and the economic pillar was only partially reflected in the provisions of the Treaty. During the negotiations,,

French government expressed its desire of counter-balancing the powerful independent European Central Bank with an ‘economic government’ for the EMU, the latter meaning more power to the ECOFIN for the formulation of EU-wide economic policies. This proposal was sustained by both economic and political arguments: setting up an ‘economic government’, it was said, is essential to ensure the democratic accountability for EMU governance. The idea of an ‘economic government’ was totally opposed by the Germans and, as a consequence of Germany’s relative bargaining power, the term ‘economic government’ was dropped out of the negotiations.

The economic pillar of the EMU was therefore reduced to the provisions of art 103 and art 104. . Art 103 called the Council to adopt Broad Economic Policy Guidelines (BEPG) and to conduct multi-lateral surveillance to ensure closer coordination of economic policies. Art 104 gave to the Council the right to bring actions against governments running high public deficits.

First period (1996-1999)

In 1996, when Notre Europe is created, the institutional design of the Euro zone is again object of debate. Germany has just announced its intention to establish a 'stability pact' to concretise and strengthen art 104 provisions on fiscal discipline, and this has created again a conflict between Germany and France. In particular, during the negotiations of the Pact, the French government pressures for broadening the scope of the Pact in order to convert it into a real instrument of macro-economic policy coordination. In the end, however, the German position prevails and, despite the addition of the word 'growth' in the title, the Pact remains narrowly focused on fiscal discipline.

The reinforcement of the mechanism of fiscal discipline aggravates a situation which is already viewed as disproportionate by some. two other factors are object of concern. First, during the first years, the Broad Economic Policy Guidelines have not worked as an effective mechanism of economic policy co-ordination. The pressures to meet the Maastricht criteria have converted them into a mechanism to monitor national performance in the reduction of public deficits and inflation. Second, while national fiscal balances have been significantly improved during the first half of the 1990s, economic growth has stagnated.

These concerns lead Jacques Delors in 1997 to put forward its proposal of an "***Economic Policy Coordination Pact***". The idea of Delors is to set up a Pact concretising and strengthening art 103 Treaty provisions on economic coordination, as the Stability Pact did for art 104 provisions on fiscal discipline. In particular, Delors foresees a strengthened procedure for the formulation of the BEPG. The new procedure would present three important innovations with respect to the old one;

- The Commission would present its recommendation of BEPGs directly to the European Council, not to ECOFIN.
- BEPGs would be broader in scope (not only aimed at ensuring fiscal consolidation, but also at stimulating growth and employment in Europe)
- Before being sent to the Council, the Commission proposal would be subject to consultation and debate with various actors (The ECB, the European Parliament, the ECOFIN, the Employment and social Affairs Council among others).

During this same year, *Notre Europe* launches two initiatives related to the issue of economic governance in Europe. The two will be grounded on a similar interpretation of the facts: Europe has consolidated its finances, but it has failed to stimulate economic growth and employment. Mechanisms for policy coordination should be strengthened and re-oriented to foster economic growth and employment.

This is the main idea inspiring the first NE study on this topic. The paper, written by Pierre Alan Muet and entitled "***Lack of Economic Growth and Unemployment: The Costs of Non-Cooperation***" compares European and US economic performance and macro-economic policies during the 1990s. The main conclusion of the study is that the low European economic performance of the 1990s has been due to the lack of coordination of economic policies. In particular, the paper links Europe's difficulties to redress the economy after the

1993 recession to "Europe's inability to implement expansionary policies", thus questioning the dominant approach at that time, which points at market rigidities and structural factors as the main causes of slow growth and unemployment in Europe.

The need to enhance and strengthen economic policy coordination is also one of the main conclusions reached in the seminar organised by Notre Europe in May 1997. Under the title "***Europe in Quest of Economic Policy***, the seminar brings together around 300 academics, EU officials and high-level politicians to discuss on economic governance in Europe. The discussions reveal a general consensus on the need to co-ordinate efforts to stimulate growth and employment in Europe. There are, however, some disagreements on the causes of low growth and high unemployment in Europe, and thus the scope and type of coordination required. Some participants consider that structural rigidities are the main problem of European economies, and therefore stress the need to coordinate structural reforms. Others, while accepting the need to coordinate structural policies, consider that the latter should be accompanied by the definition of a common macro-economic strategy oriented to stimulate growth and employment. In the conclusions, Jacques Delors welcomes the existence of a consensus on the need to strengthen mechanisms for policy coordination and recalls some of the ideas contained in his proposal of an "Economic Policy Coordination Pact". He stresses the importance of ensuring the participation of the 'institutional triangle' in the formulation of the Economic guidelines (of "preserving the basic philosophy that has always inspired the process of European construction") and defends the need to involve both the Ministries of Finance and the Ministries of Employment and Social Affairs into the definition of the BEPGs (the need to "establish an equilibrium between traditionally different sensibilities"). He also alerts on the dangers of linking the debate on economic governance to the question of ECB independence, and admits that the use of the term "economic government" might be counter-productive.

In March 1999, three months after the introduction of the Euro, *Notre Europe* publishes a study entitled "***Succeeding in the EMU*"*.*** The study, elaborated in cooperation with the *Centro Europa Ricerche*, explores the potential risks that the creation of a single currency zone might entail and evaluates the capacity of existing institutional arrangements to prevent or combat these risks. The study focuses on the medium-term risks for macro-economic stability, hence leaving aside the issue of coordination of structural reforms. Nevertheless, it hints at the possibility for macro-economic policies to play a role in "making national structural reforms socially acceptable" and recommends launching Community structural actions having a genuine 'added value', such as financing Trans-european transport and energy infrastructures or creating a European risk capital market to facilitate SMEs access to finance.

The study cites four potential risks of non-coordination (difficulties to react to symmetric shocks, difficulties to smooth the effects of asymmetric shocks, fiscal competition and social dumping) but focuses in particular on the first two. To react to symmetric shocks, it recommends:

- Building up a "constant and profound dialogue" between fiscal and monetary authorities in order to ensure a coherent policy mix in the EMU area
- Ensuring an effective external representation for the Euro-zone. The study recommends in this respect a tripartite delegation for international forums, composed of representatives of the Commission, the Council and the ECB.
- Ensuring a coordinated action between national governments and the ECB to define an appropriate exchange rate policy. Written after the 1997 Luxembourg Council (which restricted to exceptional circumstances the possibility for the Council to formulate 'general guidelines' for exchange rate policy), the study alerts in particular on the risks

of leaving the exchange rate policy at the hands of the ECB, converting it into “a derived outcome of the monetary policy”.

As regards asymmetric shocks, the study recommends:

- Ensuring that the Stability and Growth Pact gives enough margin of manoeuvre to leave automatic stabilizers play their role
- Coordinating budgetary policies “to remedy national governments’ low incentive to put into action counter-cyclical policies”
- Creating a Community “cyclical stabilisation fund”, which would operate as an automatic device providing temporal financial assistance to those countries affected by a local shock.

The last section put forward various proposals to improve the EMU institutional arrangements. In line with the 1997 Delors proposal, it is recommended to establish an “Economic Policy Coordination Pact” to improve and strengthen the procedure for the formulation of the BEPG. The paper also suggests reinforcing the procedure for multilateral surveillance, by giving to the Council the possibility of applying deterring measures (such as inviting the European Investment Bank to review its credit policy or reducing structural funding transfers to a given country)

Second period (2001-2005)

The launch of the Euro in 1999 practically coincides with the beginning of a period of economic recovery in Europe (1999-2000). During these first years, increased levels of activity and high tax receipts make it easy for Member States to satisfy the Stability Pact rules, and many of them make progress towards balancing their budget. Yet, rather than adopting a counter-cyclical behaviour, during this period some countries behave pro-cyclically, profiting from exceptional revenues to finance tax cuts. In 2001, as economic circumstances change, some of them find with no margin of manoeuvre to palliate the effects of recession and see their deficits surpassing the ceiling imposed by the SGP.

The breach of SGP fiscal rules as well as ECOFIN’s lenient attitude towards infringements opens a debate on the appropriateness and effectiveness of the SGP. In particular, the pact will be object of three main criticisms. First, being focused on actual rather than cyclically-adjusted deficits, it results in insufficient constraints on lax fiscal policies during good times and excessively tight constrains in bad times. Second, it pays attention to short-term fiscal stance rather than long-term fiscal sustainability (it is focused on deficit rather than on long-term debt). And third, being too rigid and following a “one size fits all” approach, it does not take into account the economic characteristics of each country.

Apart from that, the year 2000 witnesses the launch of a co-ordinated strategy to stimulate growth and employment in Europe, the Lisbon strategy. The establishment of this strategy will put an end to previous debates on the nature of European economic problems and the type of policy co-ordination required for stimulating growth and employment. In the years after its inception, however, many national governments will fail to reach the targets agreed in Lisbon, especially those related to public investment on R&D, education and so on. This will open a debate on the compatibility between the Lisbon strategy and the strict budgetary discipline imposed by the Stability and Growth Pact.

During this period, *Notre Europe* contributions to the debate on EMU economic governance will be mostly centred on these two issues; that is, the reform of the stability and growth pact and the compatibility of this pact with the Lisbon strategy.

The need to reform the Pact is one of the main conclusions of the study written by Lluís Navarro in 2001 (“***As the Euro prepares for take off: A critical review of the first three years of EMU”)***. The study is a detailed examination of the performance of the EMU institutional arrangements during the first three years of existence. The main conclusions of the study are that.

- The Stability and Growth Pact is too rigid, ill-adapted for ‘good times’ and too narrowly focused on the short-term. Besides, it does not take into account more qualitative aspects of public finances (the structural nature of public finances or the tax burden) and does not serve to define the aggregate fiscal policy stance of the Euro zone.
- BEPG are too broad and imprecise to be effective
- The ECOFIN is not an operational body to coordinate economic policies
- The absence of a political authority alongside the ECB to speak on behalf of the Euro damages the credibility of the new currency and the representation of the zone in international bodies.

To solve these problems, the study recommends:

- Giving more substance to the Euro-group
- Defining a reference framework for economic policies in the Euro area and a code of conduct setting up principles to guide policy choices on budgetary and tax policies.
- Re-defining the Stability and Growth Pact rules and strengthening the procedure for its implementation (by improving the content of the stability programmes and better integrating EU and national processes)
- Strengthening BEPG with the establishment of benchmarks and introducing into them a section specifically focused on the Euro area.
- Giving to the Commission a larger role in the Euro zone’s political representation and communication

How to reform the SGP pact is the question addressed in the policy paper written by Hugo de Sousa in April 2003: “**The Future of the Stability and Growth Pact as a tool for economic policy co-ordination**”. Written against the background of the conflicts surrounding the French and German deficit rule infringements, the Paper provides some recommendations to strengthen the implementation of the Pact and to convert it “into a real mechanism of economic policy co-ordination” (although the use of this expression might seem exaggerated in the light of the policy recommendations put forward in the paper). After an analysis of the problems surrounding the Pact, the paper recommends reinforcing its sanctioning mechanism, paying greater attention to national debt values and coupling the SGP with a separate pact that would incorporate the Golden Rule of public finances, whereby investments in line with the Lisbon strategy would be exempted from the deficit calculation.

Two months later, in June 2003, Notre Europe publishes another policy paper by Hugo de Sousa which is partly related to the issue of economic governance in the EMU. The paper, entitled “***The ECB and monetary policy***”, analyses ECB monetary policy and points out some measures to improve it. Among other things, the paper stresses the costs derived from the lack of coordination between the ECB, the Commission and governments. However, it also points out the difficulties “to claim for a better coordination of fiscal and monetary policies if Member States do not properly co-ordinate their economic policies first”, something which is made conditional to the creation of a President of the Euro group for a fixed time and the conversion of the Euro group into “a forum for effective policy co-ordination”.

Finally, in March 2004 Notre Europe organises a seminar to discuss the coherence between the Lisbon Strategy and the Stability and Growth Pact (***"Budgetary Discipline and Macro Economic Policy in the European Union: Are the Stability Pact and the Lisbon Strategy compatible?").*** Around 15 experts participate in this seminar, and discussions do not yield a clear answer to the question at debate. Some participants argue that restrictive fiscal policies prevent member states from undertaking structural reforms. They call for a more flexible and more differentiated application of the SGP and, in particular, for the introduction of a 'golden rule' distinguishing consumption from investment expenditures. Others consider that the establishment of a 'golden rule' would increase opportunistic behaviour and alert on the risks of introducing more flexibility to the Pact. They defend the compatibility between SGP rules and the Lisbon strategy, pointing out that fiscal consolidation is a pre-condition for sustainable growth.