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COORDINATION OF EU POLITICS

Abstract

The EMU framework for policy coordination relies on the assignment principle: the ECB is responsible for the single monetary policy, while other economic policies are carried out by governments under subsidiary principle respecting the rules and procedures laid down in the Maastricht Treaty and the Stability and Growth Pact (SGP). The policy assignment and institutional arrangements of EMU underline the importance of economic and monetary stability as a precondition for a smooth functioning of the monetary union. Policy co-ordination can be defined as supranational rules or norms which are agreed by all Member States, which leave primary responsibility for the policy area with national authorities, but set limits on their discretion. The EC Treaty mentions various forms of economic policy coordination: the broad economic policy guidelines, multilateral surveillance and the excessive deficit procedure. The maintenance of fiscal discipline is crucial for the credibility of the single monetary policy and sustained economic growth in the context of price stability. The aim of this paper is to analyze and discuss the coordination of fiscal and monetary policies in EMU, applied methods and principles of policy coordination, process of macroeconomic coordination and the assessment of the coordinative effects.

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1. Introduction

Before the foundation of the EMU, policy coordination in the EU relied on two main methods: harmonization of policies based on general rules of conduct and a delegation of the Community institutions. EMU has expanded the scope of coordination under both methods. The implementation of a common monetary policy of the Euro system is an example of delegation. Fiscal boundaries of the Excessive Deficit Procedure and the Stability Pact and growth are examples of coordination based on the rules in EMU. But in addition to these traditional methods, Maastricht process and development of the Union during the 1990's also introduced new forms of coordination that were based on dialogue, exchange of information, "peer pressure" and conviction.[1]

Reliance on "soft" law enforcement or peer pressure and persuasion, suggests that member states were not ready to give up sovereignty over their additional economic policies. The scope of policies covered by the existing coordination processes vary from budget policy, the labor market till the regulatory policies at the national level.

Coordination of policies can have narrow and broad agenda. With the narrow agenda, the coordination is limited on monitoring of national economic policies of the Member States and challenging practices, which are expected to worsen the quality of the macroeconomic performance of EMU, for example in terms of price stability. Excessive Deficit Procedure (EDP) is an example of coordination within such a narrow agenda. Coordination within the narrow agenda leaves space and freedom of member states to independently determine their political objectives, instruments and methods of implementation. Within the broader agenda, coordinating policy goes beyond that and develops an explicit framework for cooperative policies. This means agreement in

[1] "Peer pressure" (the pressure of a social group or community) - represents influence that is carried out by the "peer" group, observers or individuals in order to encourage others to change their behavior, values and attitudes to conform to the norms of the group, in the case of the EU or EMU union community.

terms of common political goals and methods for achieving the goals. Coordination of policies in EMU today, apart from the single monetary policy and the administration of the single market, continues to take place within a narrow agenda, with "unconditional" nature in the sense that the participating countries (and the ECB, where applicable) inform each other of their intentions in accordance with the given expectations about future economic conditions. What would happen if those expectations failed to realize, however, is not part of the different procedures. This limitation is particularly important in the context of coordination of monetary and fiscal policy in EMU, where key strategic issues include short term and develop transparent rules for reactions to shocks that can greatly help in guiding the expectations of the private sector.

2. Participants in the coordination process

Under Article 99 of the Treaty on European Union, the Member States should coordinate their economic policies at EU with the Council of Ministers with the participation of all 17 states and the obligatory presence of the European Commission and the ECB. Council for Economic and Financial Affairs (ECOFIN) is in charge for discussions and decisions about government deficits, public spending and taxes, while the Council for Employment and Social Affairs deals with employment and social policy. In the coordination procedures established by the agreement, the Council adopts guidelines and recommendations for economic policy based on the 16 majority votes on a proposal from the Commission. In addition, there are local committees under the Council of Ministers who prepare his work .

In order to meet the specific requirements of coordination among the participants of the eurozone, the European Council in 1997 in Luxemburg founded the Eurogroup (also known as 12 eurogroup) finance ministers of the member states of the EMU. Because the Eurogroup has no formal authority for decision - making, its role is limited to assessing the economic situation and discuss major political issues of the eurozone. The group is chaired by the Minister of the Member State of EMU which is responsible for chairing the EU, while in periods when the presidency is in the hands of a country that is not a member of EMU, by the minister of the next member of the EMU which

should assume the presidency. This subgroup of ECOFIN meets to discuss about the ECOFIN meetings.

The European Commission is present at meetings of the Council and the Eurogroup. The Commission has the right to set the political agenda for Council meetings and provide analysis for multilateral surveillance. Economic and Financial Committee (Economic and Financial Committee-EFC) has advisory and preparatory functions for Council meetings. It consists of representatives of national administrations and the national central banks, as well as two representatives from the European Commission and European Central Bank. Within the limits set by the agreements negotiated by national governments, the two institutions, EFC and EU played a leading role in the coordination process, for example, by proposing and developing different procedures discussed below. While the European Commission and EFC cover the macroeconomic and financial issues, the Economic Policy Committee (Economic Policy Committee-EPC), which consists of representatives from the Ministries of Economy, is primarily responsible for structural policies.

EMU experience suggests that the willingness of governments to “peer” pressure is not the same in all countries. Large states, in particular, are less likely to respond to peer pressure on the desired way, because the desire to be "good European" usually plays a much weaker role in their domestic policies than in smaller countries. This is indicated by the observation that the share of EU initiatives in the overall legislative initiatives is generally lower in the parliaments of large countries such as Germany, where 15-20 % of all initiatives due to the implementation of EU initiatives (see von Beyme 1997), than in smaller countries like Belgium, where it is around 50 %.

The collapse of fiscal discipline observed in the period 1999-2001, and the fact that France and Germany have taken significant tax measures without correspondonce to their stabilization programs also supports the impression that the effectiveness of peer pressure to ensure reliable large commitment of members is limited. Effectiveness of the recommendations made at EU level to guide national budget recommendations is limited by several procedural hurdles. In many Member States of the EMU, program and budget stability are prepared by the various administrative units. Hence, the relationship between these processes is weak in many countries. A further difficulty in this context is that the procedures for coordination of policies do not always include

relevant parties (actors) nationwide. Indications from the negotiations at EU level often lead only to statements with good intentions in order to convince other relevant actors on national level.

Article 113 forms the basis of the agreement for dialogue between the Council and the ECB. It provides for the participation of the ECB on Council meetings where they discuss issues related to monetary policy. In turn, the President of the Council shall be entitled to participate in meetings of the Governing Council of the ECB and to submit proposals for consideration by the Governing Council. However, it should be noted that although the President of the EU Council represents all states, however, it is not always a good interlocutor of the ECB to discuss the policy mix in the euro area. This is partly recognized in practice when the presidency of the EU falls under a non- eurozone member by which the President of the Council is represented by the chairman of the Eurogroup, i.e. the Minister of Finance of the next Member State to preside over EMU. President of the ECB is always invited to participate in meeti
ngs of the Eurogroup.

The process of Cologne, informal macroeconomic dialogue, was introduced under the German presidency in 1999. It consists of a two-year, informal consultations between public authorities and representatives of the social partners, without setting goals. The social partners are represented by their respective organizations at European level. The dialogue focuses on issues of monetary policy, fiscal policy and wage policy. The exchange takes place at the political and technical level between the ECB, ECOFIN, Councils of Labour and Social Policy, the Commission and the social partners.

3. Macroeconomic coordination

The open method of coordination, introduced the Summit in Lisbon, is essential to coordinate the processes of coordination in accordance with the objectives of the EU. The last method is not an additional process to others (such as *Broad Economic Policy Guidelines-BEPGs, the process of multilateral surveillance, the Excessive Deficit Procedure, the Stability and Growth Pact, Cologne Process),* but the concept of how to link existing procedures. His task is to highlight the fact that the processes are interacting with political objectives, such as employment and growth .

Under Article 99 of the TEU (Treaty if EU), the Guidelines of broader economic policy (BEPG) form the center of the process of coordination of economic policy at the community level. BEPG consolidate various existing processes (Luxembourg, Cardiff and Cologne) and seeks to harness the synergies between them. BEPG also references the form of multilateral surveillance procedure, under which control the consistency of national economic policies BEPG and functioning of EMU in general.

The multilateral surveillance procedure implies the ability to make reliable estimates or public policy evaluation of certain Member States and to provide confidential and public recommendations to their governments. European Council decides by unanimous vote for BEPG, on the proposal of the European Commission and the ECOFIN recommendations. From 2001 onwards, it is used an improved framework for developing and monitoring the implementation of BEPG, which explicitly includes various decision makers and actors at national and EU level in order to strengthen the accountability for final implementation.

As in the period before EMU, the coordination of economic policy aims to ensure that countries will not engage in policies that undermine the smooth functioning of open markets - competitive devaluations are a traditional example. However, a broader eurozone needs policy coordination**.** The distinction between the EU and EMU is emphasized especially in this context. The BEPG does not make sufficient distinction between economic goods that are exchanged between all member states, such as the single market, and those that are exchanged between Member States of the euro area, such as price stability in the EMU. At EU level, the internal market is a reference point for policy coordination. As in the period before EMU, the coordination of economic policy aims to ensure that countries will not engage in policies that undermine the smooth functioning of open markets - competitive devaluations are a traditional example. However, a broader eurozone needs policy coordination.

Fiscal policy remains in national governance of the Member States of the EMU, but under several restrictions. Basic procedures for the implementation of fiscal policy in the EU are: an excessive deficit procedure (EDP), multilateral surveillance procedure (MSP - Articles 99, 100, 111 TEU) and the Pact for Stability and Growth (SGP). The rule "No-Bail-Out" or "no salvation" (Article 103 of the TEU, Article 21 of

the ESCB Protocol) protects member states to become responsible for the financial obligations of the other members against their will.

EDP includes term (Article 3 of the Protocol) that member states of the EMU should implement appropriate institutions at the national level to facilitate the fulfillment of their commitments to sustainable public finances. Unlike the obligation of all Member States to have independent central banks, however, there is no explanation of what this commitment means in practice. For members of EMU, EDP is an unconditional obligation to avoid excessive deficits. In addition, EDP calls for medium budget positions close to balance or surplus. The higher the ratio debt/GDP of a country, the greater should be its efforts to quickly reduce the ratio. According to this pact, if a country has an excessive deficit, it should immediately take corrective action to reduce the budget deficit. EDP and SGP allow the imposition of financial sanctions in such situations - a feature that distinguishes them from other procedures of coordination. In the context of the SGP, Member States of the EMU are required to publish annual stabilization programs which present major fiscal decisions and budgetary choices on the path towards the medium-term objective for budgetary positions close to balance or surplus. Council considers that the strategy of budgetary policy and economic targets continue to meet the requirements of SGP and BEPG . In order to prevent an excessive deficit, the Council may give early warning in accordance with Article 99 of the Treaty.

Namely, although the combined application of EDP and SGP confirms the importance of fiscal discipline for the conduct of monetary policy, the practical operation of these agreements has not been satisfactory in the EMU for several reasons. **First**, procedures focus on the performance of individual Member State without taking into account the position of overall fiscal policy of the euro area as a whole. Implicitly, the organizational structure of these contracts is based on the assumption that to be close to equilibrium is unconditional best contribution of fiscal policy to macroeconomic stability in the euro zone. While this may be true in the long run, more analysis of eminent economists shows that stability requires different combinations of monetary and fiscal policies in different phases of the business cycle. **Second**, the procedure focuses on narrow deficits and debts. In the context of policy coordination, emphasizing the importance of moderate borrowing in EDP and SGP is justified only if there is a strong presumption that national fiscal policies affect macroeconomic

performance in EMU and cause horizontal spillover effects mainly through their capital markets.

Under the existing framework for coordination of policy formulation and monitoring the achievement of the objectives will be conducted within BEPG. Other processes, such as EDP and SGP, as well as processes of Cardiff and Luxembourg described below, aim to provide a detailed analysis of the relevant policy areas. Namely, it is interesting to note that the recommendations were directed to Ireland by the Commission and the Council in 2001 for greater fiscal disicpline were carried out under Article 99 (BEPG), although the analysis was done according to the SGP (Fisher and Reitano, 2001). Deviations occurred in the past and more recently witnessed the incompleteness of the framework for coordination of fiscal policy provided by EDP and SGP.

However, in order to make any assessments about the coordination of policies, it is necessary to know the overall legal and informal framework and appropriate processes that Member States should respect and implement.

4. Assessment of the coordinative effects

The ongoing process of policy coordination in the last few years have proved inadequate for ensuring fiscal discipline and effective policy coordination in EMU. Numerous criticisms were directed at the weaknesses of these coordination mechanisms and fueled significant debate in the direction of reforming the overall governance framework and implement the necessary measures to strengthen the coordination of fiscal policies and stability in the eurozone and the European Union. Through the analysis presented in the previous section, I realized that in the long run monetary policy can achieve price stability without cooperating with fiscal policy. The central bank can choose the rate of inflation for monetary union without affecting the output of individual Member State or the Union as a whole. However, in the short term, there is potential conflict between monetary policy and national fiscal policies, since both interact in the determination of aggregate demand in the monetary union. If the central bank firmly targets price stability, fiscal policies at the national level will result in clear distributional conflict (Jürgen von Hagen and Susanne Mundschenk, 2002). Governments will fight for a larger share of aggregate demand to achieve their desired

levels of output, while the central bank will offset the combined fiscal impulses. If fiscal impulses are expensive, it will appear strategic equilibrium where the central bank will prevent shocks to the demand and aggregate fiscal stance will resist shocks on the supply side. Namely, if the central bank tolerates deviations from price stability in the short term, fiscal and monetary policy in this case would be completely interdependent on the aggregate level. Given the fact that each of these authorities affect the goals of other authorities, coordination of policies between them is more important in achieving the desired results for both authorities. Ignoring the interdependence between monetary policy and national fiscal policies in the short term will lead to undesirable macroeconomic performances on monetary union. Many economic analysys argue that limiting fiscal policy on the operation of automatic stabilizers do not address the question of policy coordination. Rather, it destabilizes aggregate output and implies that countries will compete for the aggressiveness of their optimal automatic stabilizers as a result of the implemented monetary reaction .

The answer to these short-term conflicts requires agreements between Member States on common stance of fiscal policy on aggregate level, harmonization of fiscal stance with the union's monetary policy, procedures that explicitly represent aggregate preferences regarding the replacement of output and inflation at EMU level, and making optimal choices about these preferences. Existing processes and mechanisms for policy coordination are inadequate to address relevant conflicts at the EMU. They are not sufficiently focused on the EMU macroeconomic variables and provide a framework for binding agreements between governments and generally between the central bank and individual governments.

In fact, these processes of policy coordination may be able to provide a basis for expressing distribution conflicts between member states, clarity about the negative effects that the policy of one country may have on other countries through the EMU variables and significant "peer" pressure to encourage necessary reforms. However, they do not provide a framework for detailed analysis of important conflicts or binding agreements between governments to ensure the consistency of their individual fiscal policies with the political goals of national and aggregate level of monetary union. Hence, the current institutional arrangements largely maintains the Member States in an uncooperative political game. One implication is that the central bank law does not want

to engage in joint policy-making with the fiscal authorities, because it can not count on the reliability and safety of possible agreements with national fiscal authorities. Thus, lack of commitment and responsibility between governments implies inability to achieve effective coordination and commitment between monetary policy and national fiscal policies.

5. Conclusions

The global financial crisis exposed weaknesses in the economic governance framework of the EU, and of the euro area in particular, and severe shortcomings in its implementation. Some Member States had already accumulated large fiscal imbalances in "good times". However, the Stability and Growth Pact (SGP) – the fiscal surveillance mechanism in place to safeguard the stability of Europe's Economic and Monetary Union (EMU) – did not provide sufficient incentives for the correction of these fiscal imbalances, particularly after the reform of the SGP in 2005. The financial and economic crisis led to a further deterioration in fiscal positions, owing to the effects on budgets of automatic stabilizers in the tax and benefit systems, the fiscal stimulus packages introduced by governments to counter the economic downturn, and the support provided to the financial sector.

The Treaty on the Functioning of the European Union (TFEU) specifies a clear division of responsibilities between European and national policy-makers in EMU. Monetary policy is inherently indivisible in a monetary union, and in the euro area it is thus conducted at the supranational level. By contrast, economic policies, such as fiscal and structural policies, have remained largely the competence of national governments and reflect national political preferences. Close coordination between monetary and fiscal policy is essential for sustainable economic growth in a context of price stability and viable external accounts. Effective policy coordination makes it easier for policymakers to achieve their objectives efficiently, in part by ensuring their commitment to mutually agreed objectives. Without efficient policy coordination, financial instability could ensue, leading to high interest rates, pressures on exchange rates, rapid inflation, and an adverse impact on economic growth.

Before EMU, policy coordination in the EU relied on two main methods, harmonization of policies based on common rules of behavior,

and delegation to community institutions. EMU has expanded the scope of coordination under both methods. EMU has expanded the scope of coordination under both methods. The conduct of the common monetary policy by the Euro system is an example for delegation. The fiscal strictures of the Excessive Deficit Procedure and the Stability and Growth Pact are examples for rules-based coordination in EMU. Policy coordination can have a narrow or a broad agenda. With a narrow agenda, coordination is limited to monitoring the national economic policies of the member states and challenging practices that are expected to worsen the quality of the EMU's macro economic performance, e.g. with regard to price stability. The Excessive Deficit Procedure is an example for coordination under such a narrow agenda. Coordination with a narrow agenda leaves the member states the freedom to choose their policy goals, instruments, and methods of implementation. With a broad agenda, policy coordination goes beyond that and develops an explicit framework for cooperative policies. This requires agreement on a set of common policy goals and methods to achieve these goals. Apart from the single monetary policy and the administration of the Single Market, today policy coordination in EMU proceeds under a narrow agenda.

Existing processes for policy coordination in EMU may perhaps provide a basis for expressing the distributional conflicts among the member states, for expressing concerns about policies in one country that could have negative effects on others through the EMU aggregates, and for peer pressure encouraging reforms. However, they provide no framework to analyze the relevant conflicts in detail or to arrive at binding agreements among the governments assuring the consistency of their individual fiscal policies with their policy goals at the national and the aggregate level. Thus, the current institutional setup largely keeps the member states in a non-cooperative policy game. One implication is that the central bank is rightfully reluctant to engage in cooperative policymaking with the fiscal authorities, as it cannot count on the reliability of agreements it might enter into with the governments. Thus, the lack of commitment among the governments implies an inability to commit between the monetary and fiscal authorities.

The current economic governance framework was never fully implemented and has even been weakened since the start of EMU. It thus failed to prevent the crisis in the euro area. The economic surveillance framework in place for fiscal policies was not applied sufficiently rigorously and available sanctions were not implemented. According to

the Economic Commission there are several measures that are going to improve the economic governance framework of the EU: (1) more "automaticity" and less room for discretion in the operation of the preventive and corrective arms of the fiscal and macroeconomic surveillance framework; (2) the creation of a macroeconomic surveillance framework with a clear focus on euro area countries that are less competitive, have sustained current account deficits or have high levels of public and private debt; (3) strict deadlines to avoid lengthy procedures, and the elimination of "escape clauses"; (4) the introduction of additional political and reputational measures for compliance with the rules of the governance framework; (5) more ambitious benchmarks for establishing the existence of an excessive deficit; (6) the early and gradual application of financial sanctions under the proposed macroeconomic surveillance framework; (7) more ambitious requirements as regards the adjustment path towards a country's medium-term budgetary objective; (8) improvements in the quality of annual and quarterly economic statistics, in terms of both their timeliness and their reliability; (9) guaranteed quality and independence of fiscal and economic analysis; (10) a commitment on the part of the euro area countries to swiftly enhance their national budgetary frameworks; and (11) the creation of an effective crisis management framework, with any financial assistance being based on strong conditionality that avoids moral hazard.

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