

# Only One Bed for Two Dreams: A Critical Retrospective on the Debate over the Economic Governance of the Euro Area\*

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## Abstract

This article investigates why economic governance of EMU remains a matter for disagreement, revisiting in particular the Franco–German debate about the appropriate architecture. Is it due to divergent policy priorities within the same analytical framework? To different economic models? Or to non-economic considerations, such as the link with political union?

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## Introduction

Construction work on the European single currency is not yet complete. The political arm, the economic policy arm of the Euro-pean Economic and Monetary Union needs to be strengthened. European economic and currency policies are not just about money ... I staunchly plead for a more strongly co-ordinated European economic policy, so that monetary policies can be underpinned by economics in such a manner that something will come out of all these economic and currency policies that will boost European growth and from which the rest of mankind will be able to greatly profit.

(Juncker, 2006)

Discussions on the appropriate economic governance of European monetary union started as soon as the project for a common currency began to be

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outlined and they have not yet ended. Throughout the history of economic and monetary union (EMU), from the Werner report of 1970 to the 2005 reform of the Stability and Growth Pact (SGP) and the 2006 discussions on the role of the Eurogroup in the identification and the correction of economic divergence within the euro area, advocates and opponents of economic policy co-ordination have been exchanging arguments in a never-ending controversy. On the one hand, a school of thought has consistently been arguing that once a core set of fiscal discipline principles are enforced, there is no need for further constraints on national economic policy autonomy; on the other hand, another school of thought has been as consistently claiming that a well-functioning union cannot be based on fixed rules alone and that some form of fiscal co-ordinated decision is also required.

The contrast with the monetary side is striking. Here also, there has been no shortage of controversies since the 1970s: think of the discussions between the 'economist' and the 'monetarist' approaches to monetary unification, between the advocates of central bank independence and the doubters, between the proponents of parallel currencies and the defenders of the single currency, between those who had faith in monetary rules and the supporters of inflation targeting, etc. Those controversies were settled one by one and while new debates have emerged and will certainly still emerge, there is a learning process at work. Today's discussions may have some common features with those of yesterday, but they are not simply a way to reopen the same eternal and unsettled controversy.

The purpose of this article is to investigate why economic governance of EMU remains an matter for disagreement. Is it due to divergent policy priorities within the same analytical framework? To a reliance on different economic models? Or to non-economic considerations, such as the link with political union?

In order to answer that question, I begin with an historical review of how the debate developed before the launch of the euro (section I). I then take up the analytical discussion in Section II. Section III is devoted to the evolution of the discussion in the light of experience, since the launch of the euro. Finally, I draw conclusions.

## **I. Setting the Scene: The Pre-1999 Discussion**

### *Early Blueprints*

Early official thinking on monetary union regarded some form of fiscal union as a natural and necessary complement to the creation of a single currency. This stance was very clear in the report prepared in 1970 at the request of the

European heads of state and government by Pierre Werner, then Prime Minister and Minister of Finance of Luxembourg. The report (Werner, 1970) claimed that in EMU, 'the margins within which the main budget aggregates must be held both for the annual budget and the multi-year projections will be decided at the Community level'. A few years later, the McDougall (1977) report would go even further and advocate a partial centralization of the budget, suggesting that the single currency would require the common budget to reach at least 5 per cent of GDP.

This thinking reflected the Keynesian consensus of the time and the Mundellian view of the scholars of EMU (Kenen, 1969). It could have been expected to disappear in the 1980s and in fact, the idea that the EU budget would have to be multiplied by a factor of five or more to support the single currency had effectively been abandoned when discussions on EMU resumed in the late 1980s. Yet the project of achieving fiscal union through co-ordination remained alive. The Delors report of 1989 which was prepared by a committee (essentially formed of central bankers) indicated that economic and fiscal decisions 'would have to be placed within an agreed macroeconomic framework and be subject to binding procedures and rules' (Delors, 1989). This, the report added, 'would permit the determination of an overall policy stance for the Community as a whole, avoid unsustainable differences between individual member countries in public-sector borrowing requirements and place binding constraints on the size and the financing of budget deficits'.

Interestingly, this last sentence based the case for 'binding procedures and rules' on two distinct arguments: first, the need to determine the overall policy stance – a Keynesian co-ordination argument; and second, the need to place constraints on the size of budget deficits – a fiscal discipline argument. Those two requirements would later form the basis for the two pillars of EMU in the Maastricht Treaty.

The fiscal co-ordination argument featured prominently in the paper written by Alexandre Lamfalussy (a Belgian academic who would become the chairman of the European Monetary Institute, the precursor of the ECB) for the Delors report. This article deserves to be quoted at length as it encapsulates the ambiguity of the discussion: 'The combination', Lamfalussy wrote, 'of a small Community budget with large, independently determined national budgets leads to the conclusion that, in the absence of fiscal co-ordination, the global fiscal policy of the EMU would be the accidental outcome of decisions taken by Member States. There would simply be no Community-wide macroeconomic fiscal policy ... Even within a closed economy, this would be an unappealing prospect ... [Therefore] fiscal policy co-ordination would appear to be a vital element of a European EMU and of the process towards it. Appropriate arrangements should therefore be put in place which would allow

the gradual emergence, and the full operation once the EMU is completed, of a Community-wide fiscal policy. Such arrangements should also aim at avoiding disruptive differences between the public sector borrowing requirements of individual member countries' (Lamfalussy, 1989).

This quotation clearly indicates that Lamfalussy regarded the development of a Community-wide fiscal policy as the primary objective and the avoidance of excessive national deficits as a complementary one. At the limit, co-ordination was a must and fiscal discipline, the natural and welcomed effect of an appropriate fiscal co-ordination framework.

### *Maastricht*

The Maastricht negotiations thus started on an ambiguous basis. Everybody was seemingly agreeing on the need for 'binding rules for deficits', but different players had different rationales in mind. Among the two main ones were Germany and France, the first primarily focused on the preservation of price stability and adamant that excessive deficits had to be avoided. The second favoured some form of co-ordination through the creation of an 'economic government', an expression that had been adopted by the late Pierre Bérégovoy, at that time Minister of Finance, and whose exact meaning would remain somewhat obscure. In the eyes of the French (who had rather grudgingly agreed to relinquish the control of the central bank), it was politically important to give substance to an economic pillar beside the monetary pillar represented by the ECB and 'economic government' could contribute to it through speaking with one voice externally, co-ordinating economic policies and conducting exchange rate policy.<sup>1</sup>

The French were not opposed to using the European framework to restrain fiscal profligacy (they could even see some potential benefit in imposing discipline from above). Similarly, as long as it did not mean control of the central bank by the Council, the Germans could live with an economic government (which somehow echoed the concept of 'political union', an equally vague notion that was widely regarded in Germany – including by the Bundesbank – as a precondition for monetary union). Neither of the two main players therefore had the motive to oppose the view of the other and there was room for compromise.<sup>2</sup>

<sup>1</sup> See Dyson and Featherstone (1999) for a detailed account of the discussions prior to Maastricht.

<sup>2</sup> I am speaking here of a French and a German approach, not only because the two countries played the two key roles in the birth of the euro, but also because they epitomize two concepts of EMU which were and remain central to the discussion. Taking into account the views of the other participating countries on the issues that are discussed here would not substantially modify the conclusions (see Dyson and Featherstone, 1999, for a detailed account).

The result was a treaty framework based on two pillars: a 'German' one (Art. 104), which states that 'Member States shall avoid excessive government deficits'; and a 'French' one (Art. 99), which states that 'Member States shall regard their economic policies as a matter of common concern and shall co-ordinate them within the Council'. A crucial difference between the two pillars was however that they were of unequal strength: while Art. 104 includes a specified objective, numerical targets and a detailed procedure (the excessive deficit procedure, or EDP) leading up to pecuniary sanctions, Art. 99 is a general-purpose provision with no corresponding policy rule or 'teeth'. Indeed the instruments it relies on, the so-called Broad Economic Policy Guidelines and the surveillance of national policies within the Council, are both of limited effectiveness. With no legal basis for sanctions, the most Art. 99 can lead to is a non-binding recommendation by the Council.

The same pattern can be observed as regards exchange rate policy. Here also, Germany's goal was to avoid the risk of price stability being jeopardized by exchange rate intervention and France's goals were to preserve the single currency from the risk of excessive appreciation and to retain the possibility of using exchange rate policy as an additional policy instrument. Here again, the resulting compromise, while responding to a certain degree to French demands, went a long way towards meeting German concerns: Art. 111 states that 'the Council may formulate general orientations for exchange-rate policy', but this requires consultation of the ECB and it is explicitly stated that 'these general orientations shall be without prejudice to the primary objective of the ESCB [European System of Central Banks] to maintain price stability'.

### *Last Additions*

The first pillar was strengthened in 1997, prior to the introduction of the euro, with the adoption of the SGP (technically secondary legislation based on Art. 104) at the insistence of German Finance Minister Theo Waigel, who worried about acceptance of the future currency by German public opinion. The aim was to remove the margin for discretion left by Art. 104, to ensure that the excessive deficit procedure would be implemented according to a predetermined timetable and to agree that the eventual sanctions would be levied according to a predetermined formula. In the eyes of its proponent, the Stability Pact should have replaced a decision on the implementation of the excessive deficit procedure by a rule (Stark, 2001). However, the proposal met (especially French) opposition within the Council and the eventual (Belgian) compromise was the adoption of a rules-based framework that did not remove the need for

Council decision at each step of the EDP but created the presumption that the Council would vote according to the provisions of the Pact.<sup>3</sup>

The second pillar was, however, also complemented in the same year by the agreement on the creation of the Eurogroup. The proposal had come from France, where the newly elected Jospin government was advocating a venue for euro area policy discussion and co-ordination. In the words of Dominique Strauss-Kahn (1997), then French Finance Minister, its purpose was both political (to avoid the ECB being regarded as 'responsible for growth, employment, or even unemployment') and economic ('to match increased monetary interdependence by closer economic and budgetary co-operation'). The idea was grudgingly accepted by the other EU members, especially the UK, on the condition that this euro area Council would remain informal and that all formal decisions would continue to be taken by the Ecofin Council.

Finally, an agreement was reached in 1997 on the interpretation of the treaty article dealing with exchange rate policy. At its meeting in Luxembourg, the European council agreed that 'general orientations for exchange rate policy' could be issued only in exceptional circumstances, for example in cases of clear exchange rate misalignment. An emblematic economic government provision was thus watered down.<sup>4</sup>

Those additions thus very much reinforced the already existing imbalance between the two pillars: with the adoption of the Pact, some more bricks and mortar were added to the first, strong one; with the clarification of Art. 111 it was made clear that the mechanism for exchange rate intervention was made of sand rather than stone; and through the creation of that new institution, the Eurogroup, another seemingly plaster decoration was added to the second, weak one. Shortly thereafter, the euro would be launched with a governance system based on this framework.

Summing up the pre-1999 debate, the call for economic policy co-ordination in a monetary union began with early discussions on the single currency. Without denying the primacy of the requirements on monetary stability and fiscal discipline, but as a complement, a school of thought consistently advocated economic policy co-ordination and requested institutions for economic governance. However, its insistence resulted in markedly weaker institutional provisions than those inspired by the need to safeguard central bank independence and price stability.

<sup>3</sup> It was in fact the Commission, not the Council, that lost discretion in the implementation of the EDP, since the Pact spells out in great detail when the Commission (which retains the monopoly of initiative) can abstain from proposing activating the procedure against a country whose budget deficit exceeds 3 per cent of GDP. This followed a 1994 decision by the Commission not to present a report on Ireland, which had deprived the Council of the possibility of launching an excessive deficit procedure against that country.

<sup>4</sup> Further clarifications were agreed on in 1999 as regards the responsibilities of the Council and the ECB as regards communication and consultations with other countries (see Henning, 2006).

## II. The Economics and Politics of Economic Governance

It was appropriate to start with the policy debate, not on the academic one, because politics remained in the driving seat along the road to EMU. It is time, however, to review the academic discussion and its impact on policy.

Generally speaking, academics had limited influence on the project for, and the design of, EMU. The choice to emphasize and safeguard the independence of the central bank was certainly buttressed by the burgeoning literature on credibility of the 1970s and the 1980s (Kydland and Prescott, 1977; Barro and Gordon, 1983). But economic analysis was used as a justification more than as a starting point for discussion and there was not much thinking or debate on the possible models for the independent European Central Bank (for example, there was hardly any discussion on the choice between goal and instrument independence).

As regards adjustments within a currency union, when the project emerged, economic literature was already equipped with a theory, that of Mundell (1961) and his immediate successors. But the conclusions from this strand of research were essentially ignored, both in the design of a framework for the single currency and in the selection of participating countries. Indeed, the main conclusion from the Mundellian approach was that suitability for a monetary union depends negatively on the underlying structural asymmetry between countries and positively on factor mobility, wage and price flexibility and the existence of a federal budget. In the event, structural criteria for membership in the euro were put aside while nominal criteria (which are irrelevant in a Mundellian setting) were emphasized, labour mobility was not encouraged, wage and price flexibility was not enforced, and there was an explicit decision not to condition monetary union on the expansion of the EU budget.<sup>5</sup>

This limited early influence, however, did not deter academics from participating in the subsequent discussions on the governance of EMU. They were quick to unbundle and address separately the three major issues that were present or implicit in the early writings of the Delors committee: first, the risks that independent fiscal policies represent for the common monetary policy and, as a consequence, the justification of corresponding limits to fiscal deficits, and the particular design of the SGP; second, the desirability of co-ordinating fiscal policies over and above what is required by the preservation of monetary stability; third (though in a much less prolific way) the links between monetary and political union. Let us take them one by one.

<sup>5</sup> The European Commission's *One Market, One Money* study (Emerson *et al.*, 1992) was an attempt at bridging the gap between theory and policy. A degree of annoyance is noticeable in its somewhat dismissive account of the Mundellian approach.

### *Fiscal Discipline*

The literature on fiscal discipline first focused on the channels through which independent fiscal policy-making may threaten monetary stability. A well-known result in the literature is that monetary and fiscal policy are not independent in the very long run: ultimately, fiscal profligacy and monetary rigour are incompatible with each other (Sargent and Wallace, 1981). The question then becomes, is there a bias towards irresponsible fiscal behaviour in a monetary union, which would justify constraints on national policies? This risk does not immediately follow from monetary union since the disappearance of the debt monetization option should, on the contrary, lead to less, rather than more deficit spending. However, it arises if governments are partisan or short-sighted, if they count on a bail-out by their neighbours in the case of financial crisis, or if they expect that, when confronted by an irresponsible fiscal behaviour, the ECB will accommodate debt creation rather than force an outright government default. Against this background, early contributions by academics and financial market economists discussed whether a fiscal discipline framework was indispensable (Bishop *et al.*, 1989; Eichengreen, 1990). Most argued that, provided the no bail-out clause is credible, there was no reason to expect governments to behave in an irresponsible way – an argument that was ignored in policy discussions.

The economic profession had therefore the motive to criticize flaws in the design of the Maastricht fiscal discipline framework (Buiters *et al.*, 1993; von Hagen and Harden, 1994) and the Stability Pact (Eichengreen and Wyplosz, 1998). Even before reform talks started in 2003, a series of contributions (see, for example, Casella, 1999; Buiters and Grafe, 2004; Blanchard and Giavazzi, 2004; Coeuré and Pisani-Ferry, 2005a) had proposed alternative schemes or at least significant reforms (Sapir *et al.*, 2004). As evidenced by the writings of policy practitioners (Buti and Franco, 2005), the economic profession succeeded in drawing the attention of policy-makers to conceptual and practical deficiencies in the SGP and in prompting discussions on its reform. Several of the criticisms were also taken on board in the amendments introduced in 2005 in the revised Pact.

Criticism, however, came from several, frequently mutually inconsistent strands. While the economic profession generally acknowledges the usefulness of an EMU fiscal framework, there are various views as regards its aims and model, from the robust defence of a rules-based system of graduated sanctions (Calmfors, 2005) to the proposal to shift the emphasis to the design of independent policy-making institutions that would be made responsible for the budgetary stance while leaving decisions on individual taxes and spending programmes to the national parliamentary process (Wyplosz, 2005). In the

absence a consensual prescription, economic analysis therefore contributed to animating the ongoing discussion on the design of rules and institutions rather than to bringing it to definite solutions.

*Co-ordination: Economics*<sup>6</sup>

Since the first plans for EMU started being drafted, there has been an abundant supply of contributions on the desirability of co-ordination – either among the fiscal players, or between them and the ECB. The issue, however, is complex, if only because it involves at least three distinct, but interrelated discussions. The first is about the overall *effectiveness* of fiscal policy; the second is about the desirability of *co-ordinating* national fiscal policies to achieve a given aggregate fiscal stance in the context of a monetary union equipped with an independent, inflation-adverse central bank; and the third is about the degree to which the appropriateness of *national* fiscal policies should be subject to joint discussion.

The effectiveness of fiscal policy is an old topic which has been revisited time and again and does not need to be surveyed here. Taylor (2000) and Allsopp and Vines (2005) remind us that, on both sides of the Atlantic, the consensus has shifted from confidence in the stabilization properties of an active fiscal policy to a sceptical stance which primarily regards stabilization as a by-product of the pursuit of low inflation and claims that instead of aiming at active stabilization, fiscal policy should concentrate on ensuring sustainability. This paradigm change was already well underway at the time of the Maastricht negotiations and was instrumental in favouring caution towards proposals for active fiscal policy. There has certainly been in recent years a noticeable move away from the absolute denial of the role of fiscal policy, especially in the US (Gali *et al.*, 2005; Feldstein, 2002). But common wisdom in continental Europe – among economist and policy experts, at least – remains that beyond the operation of automatic stabilizers, there is not much that discretionary fiscal policy can achieve, and this is part of the thinking behind the Commission recommendations (see, for example, Commission, 2006, Part IV).

As regards the pros and cons of co-ordination, an appropriate starting point for the discussion is the familiar observation that, in the presence of externalities, independent policy-making delivers a socially suboptimal outcome. In such a setting, the desirability of co-ordination depends on governments' objectives, and on the magnitude of the corresponding gains and costs, which in turn depend on the degree of interdependence (positive), on the relative importance of goods and capital channels (which affect the sign of the spillover effects),

<sup>6</sup> The discussion here is limited to the macroeconomic dimensions of co-ordination. The co-ordination of structural policies such as reforms of labour, goods and financial markets also warrants discussion (see, on these issues, Tabellini and Wyplosz; 2004; and Pisani-Ferry and Sapir, 2006).

on uncertainty about the parameters and the state of the economy (generally deemed negative), on the risk that participating governments cheat and pursue private agendas (both negative), and on the political costs of co-ordination (negative). Whether or not co-ordination is desirable in the end depends on one's priorities and judgement on the significance of the risks involved. The mainstream view among economists tends to be that the costs of co-ordination are generally likely to outweigh its benefits and that provided everyone 'puts his house in order', independent policy-making remains preferable (Alesina *et al.*, 2001). Indeed, in spite of numerous references to co-ordination in the European Treaty, before EMU Member States hardly co-ordinated their macro-economic policies.

The specific issue is whether co-ordination between fiscal authorities is desirable in a monetary union in which responsibility for monetary policy is assigned to an independent central bank whose mandate emphasizes price stability rather than output stabilization.

On the one hand, participation in the monetary union creates new channels of interdependence: any policy action that affects prices in a participating country has an impact on the union's inflation rate and thereby on the monetary policy of the central bank; in a similar vein, any policy action that affects the common current account may have an impact on the common exchange rate. The observation that, in a monetary union, the inflation rate and the current account have the character of 'club goods' (Cohen and Wyplosz, 1989; Jacquet and Pisani-Ferry, 2000; von Hagen and Mundschenk, 2003) thus prompted calls for tighter co-ordination.

On the other hand, the behaviour of the central bank makes the overall game more complex. To start with, a well-known result is that in a multiple-player setting, co-ordination between a subset of players does not necessarily improve the policy outcome. Thus, co-ordination between the fiscal authorities only (leaving the ECB out) may not be desirable. It is in fact easy to write a model where the ECB holds the leadership and where a partial co-ordination turns from positive to counterproductive once monetary policy is endogenized.<sup>7</sup> Results in this field tend to be model dependent, but they suffice to caution against the claim that monetary union *unambiguously* calls for economic policy co-ordination.

Careful treatment of the interaction between monetary and fiscal policies was provided by Avinash Dixit and Luisa Lambertini in a series of papers. They show that, if the output and inflation objectives of the central banks and the

<sup>7</sup> It is sufficient for such a result to hold to introduce both a direct, horizontal externality through which fiscal policy in one country affects the other participating countries and an indirect, vertical one through which fiscal policy also affects the common interest rate. When the two externalities somehow balance each other, internalization of the first one only is counterproductive.

fiscal authorities coincide, co-ordination between fiscal authorities or between them and the central bank is essentially irrelevant: the common objectives are reached whatever the precise policy set-up and despite any disagreement there may be on the relative weights of the output and inflation objectives (Dixit and Lambertini, 2003a). However if the monetary and fiscal authorities disagree on the objectives and even more if they are unable to commit, non co-operation between them can lead to significantly inferior outcomes (Dixit and Lambertini, 2003b).<sup>8</sup> In a single-country context, a solution to this problem is generally to let the least benevolent authority play the role of a Stackelberg leader: whatever its own objective, it internalizes the reaction of the other player and avoids counterproductive retaliation. This justifies giving leadership to the fiscal authority when the monetary one is considered benevolent: the central bank's reactions and the expectation thereof, act as a powerful disciplinary device. Furthermore, the discretion retained by the fiscal authority allows it to cope with large or unusual shocks (Allsopp and Vines, 2005; Feldstein, 2002).

This reasoning provides a valid motivation for co-ordinating fiscal policies in EMU. Against this background, a primary requirement is to avoid a failure to internalize the central bank's reaction to lead to counterproductive fiscal expansion. In a setting akin to that of Dixit and Lambertini, Uhlig (2003) shows that the outcome of independent fiscal policy-making tends to be inefficient and derives from his results a justification for a common fiscal framework such as the Stability Pact. The question then becomes, what role can fiscal co-ordination play over and above what is provided for by the Stability Pact? Can it make the aggregate fiscal policy responsive to economic developments while internalizing the requirement for discipline? For the fiscal side to play the leadership role, as it does in the UK, co-ordination would need to be much more effective than what has been achieved so far in the context of EMU. Beyond the mere indicative process currently in place, this would require procedures for joint decisions, at least in exceptional circumstances (Coeuré and Pisani-Ferry, 2005a). Whether the corresponding benefits would outweigh the cost of further restraining national autonomy remains a matter for discussion.

The third and last aspect of co-ordination regards the use of national policies to redress intra-EMU divergence in real exchange rates. The issue of divergence within the euro area was neglected in the first years of EMU before starting to gain prominence, and there is evidence that by the mid-2000s several countries were suffering from excessive, unwarranted real exchange rate appreciation (Ahearne and Pisani-Ferry, 2006). The question is, to what extent should fiscal policy be used to prevent or redress such divergence? This, again, is an old issue and there is wide consensus that once national monetary autonomy has

<sup>8</sup> Kirsanova *et al.* (2005) reproduce Dixit and Lambertini's main results in a simplified model.

been forsaken, there is a stronger role for fiscal stabilization at the national level. The less consensual question is whether there is a case for discussing and co-ordinating national responses with EMU partners. The reason for it is that macroeconomic mismanagement in a member country can impair the functioning of EMU and lead to a situation where the conduct of a single monetary policy becomes close to impossible. This is at least a motive for enhancing macroeconomic surveillance. As noted by Allsopp and Vines (2005), however, potentially disturbing debates are involved because giving that role to fiscal policy can conflict with the objective of achieving fiscal discipline.

### *Co-ordination: Politics*

There are only a few research contributions on the political case for co-ordination. This is a noticeable absence in view of the prominence of the theme in the thinking of practitioners. Ministers can be regarded as naturally biased *vis-à-vis* the issue. But also central bankers have emphasized the desirability of some form of political union that would match monetary union. According to Tommaso Padoa Schioppa, who was a member of the Executive Board for the first six years of the ECB, 'ultimately, the security on which a sound currency assesses its role cannot be provided exclusively by the central bank. It rests on a number of elements that only the state, or more broadly, a polity can provide' (Padoa Schioppa, 2004, p. 181). Padoa Schioppa further emphasizes the risks involved in a lack of fiscal co-ordination, saying that 'the Eurosystem is missing the fiscal and political counterpart that usually mediates for a central bank. This harbours the risk of the Eurosystem being seen as the only macroeconomic policy-maker in the euro area, and hence to be held responsible for any adverse development in the European economy, not only inflation but also unemployment and slow growth' (p. 57) – almost exactly the already quoted rationale for the Eurogroup given by French Finance Minister Dominique Strauss-Kahn. Padoa Schioppa therefore regards the decision to move ahead with the euro in advance of political union as containing 'an implicit commitment to the completion of the polity' (p. 181). Also Otmar Issing, another ECB Board member who previously belonged to the Bundesbank, was a staunch proponent of political union until he realized that it would not happen in parallel to monetary union.

Not many academics have tried to make economic sense of the reasoning in favour of balancing the rise of the ECB with an strengthening of the economic pillar. One exception is Goodhart (1998), whose main argument is that the one-to-one correspondence between states and currencies is a 'robust regularity' not accounted for by conventional economic theory. According to Goodhart, only the largely ignored 'cartalist' school recognizes the 'centrality of the link between political sovereignty and fiscal authority on the one hand

and money creation, the mint and the central bank, on the other'. However, Goodhart acknowledges the analytical weaknesses of the historical approach and he himself does not propose a theory of the link between statehood and the issuance of a currency. Another exception is De Grauwe (2006), for which 'in the long run, success of the Eurozone depends on the continuing process of political unification'. In his view, there are three rationales for political union in a monetary union subject to asymmetric shocks: first, political union leads to the institution of a federal budget that can offset part of the economic shocks; second, it reduces asymmetric shocks which have a political origin; third, it creates the political ties that are required for the union to survive times of strain.

The argument that the sustainability of monetary union requires some form of institutional and political backing makes good sense. It is supported by the historians' reading of the demise of the gold standard in the inter-war period: in spite of the collaboration between central banks, there was simply not enough political commitment towards it to overcome divergence (Frieden, 2006). The argument is, however, not fully worked out, especially as regards two issues of major relevance: first, why would political union necessarily improve the monetary union's resilience to shocks? In other words, in what way would common political institutions and the corresponding assignment of additional responsibilities to the Union level necessarily increase the ability of participating countries to sustain economic adjustments? Surely, a legitimate political union would make temporary strains more acceptable, but in the short term, transfers of sovereignty to the Union level, further reductions in national autonomy and recommendations from Brussels could elicit opposition. Second, assuming the argument for political union is valid, to what extent could co-ordination within the framework of the Eurogroup substitute the building of truly federal institutions? In other words, would some progress towards political union necessarily be better than no progress at all? We know from the second best theory that half-way progress sometime leads to inferior outcomes. All in all, the political argument for economic governance is not well developed in the literature.

Summing up, though the creation of the euro prompted significant research on economic policy in EMU, this literature offers ambiguous and on the whole rather weak support for the co-ordination of economic policies. There are very respectable economic arguments for it, but they are disputed and probably elicit more scepticism than support in the economic profession. Political arguments are less controversial, but they have not yet been fully worked out. There is a significant contrast here with fiscal discipline which is fairly consensual, even though the design of an appropriate incentive framework involves several controversies.

### III. Experiment and Learning: 1999–2005

As developed in Section I, the euro was introduced in 1999 on the basis of an unbalanced legal framework whose co-ordination pillar was markedly weaker than the discipline pillar. As developed in Section II, the intellectual case for co-ordination was also weaker than the case for discipline. The ‘French’ approach to monetary union could therefore have been expected to lose ground and eventually fade out, making room for the triumph of the ‘German’ one. After all, this is what had already happened in the 1980s with the European Monetary System (EMS) which had evolved towards Deutsche Mark dominance in spite of provisions claiming that the European currency unit (ECU) was at its core and that all currencies in the system had an equal role.

This did not happen in the first six years of EMU, and by mid-2006 there was still significant uncertainty as regards the evolution of the system.

#### *Economic Governance at Work*

Economic governance certainly did not deliver more than expected. The procedure upon which the implementation of the multilateral surveillance envisaged in Art. 99 was meant to be based, the issuing of Broad Economic Policy Guidelines (BEPGs) for the participating countries, proved to be ineffective. The economic rationale and analytical basis of the BEPGs remain fuzzy. It is not clear whether they aim at telling each country what policies it should adopt in its own interest, or whether their purpose is avoid countries choosing policies that could be detrimental to their partners. They involve far too many guidelines to deliver a selection of priorities, and the EU is deprived of any meaningful instrument to ensure that they are effectively implemented (Pisani-Ferry, 2003; Pisani-Ferry and Sapir, 2006). Furthermore, the BEPGs have become a ‘Brussels talking to Brussels’ exercise which remains unnoticed outside the triangle formed by the buildings of the Commission, the Council and the European Parliament.

The fate of the provisions on ‘general orientations for exchange rate policy’ in Art. 111 has been even worse: they have never been activated, though after 1999 the exchange rate first depreciated by 30 per cent against the US dollar before appreciating by 63 per cent. One of the reasons for this lack of effectiveness is that the instrument was conceived in the context of the attempts by the Group of Seven at managing global exchange rates through the definition of target zones, following the Plaza agreement of 1985 and the Louvre agreement of 1987. By the time the euro had been launched, however, such attempts had been abandoned and there was agreement to consider that, barring exceptional circumstances or severe misalignments, the determination of exchange rates had to be left to the markets. It is not clear whether there remains any prospect

for the issuance of such orientations, even in the event of significant exchange rate gyrations. What was in the early 1990s regarded by its proponents as one of the major pillars of economic governance has thus been the victim of changes in the international context.

Turning to concrete episodes, co-ordination can claim limited success. In the one case a recommendation for violating the BEPG was issued by the Council – that of Ireland in Spring 2001 – the recipient government chose to ignore it, and rightly so. At the time, Ireland was experiencing higher-than-average price inflation and the recommendation made was to implement fiscal restraint to calm down prices, although the budget was already in surplus. However, the Council recommendation was misguided as higher price increases reflected a catch-up in the price level and improvements in product quality rather than an excessive appreciation (Blanchard, 2001).

Other significant instances were the Asian/Russian crisis shock of 1998 (a consensus emerged on the inappropriateness of a fiscal expansion), the unexpected increase in tax receipts of 2000 (nothing was done to avoid national fiscal policies to turn mistakenly pro-cyclical), the 2001 agreement within the Council on the appropriateness of letting automatic stabilizers play their role (a positive development), and the post-2003 stepwise rise in energy prices (not much was concretely achieved).

Co-ordination can claim some success in building a consensus among European policy-makers through discussions within the Eurogroup and peer pressure. There was, for example, a certain collective learning process at work as regards the appropriate response to give to oil price increases, which may have contributed to making the response to the 2004–06 round of price increases less disorderly than that observed in 2000. There was also some learning in communicating on exchange rate matters, after the rough start in 2000–01, when inconsistent declarations were made on an almost routine basis. But a disappointing record remains the inability to spot and address the policy mistakes made by Portugal and Italy at the time of entry into the euro. The focus on the Maastricht nominal deficit criterion led to the fact being overlooked that the benefits from the reduction in risk premia on bond rates had been passed on to the private sector in the form of higher spending and lower taxes. Those policies contributed to triggering price increases in the non-traded goods sector that would eventually translate into an excessive real appreciation. This is precisely what effective peer pressure should have diagnosed and redressed, for example through requesting fiscal restraint over and above what the Treaty and the SGP formally called for.

Finally, it must be reminded that attempts at reforming the economic governance of EMU on the occasion of the preparation of the draft Constitutional Treaty proved unsuccessful. Even before the draft Treaty was rejected in

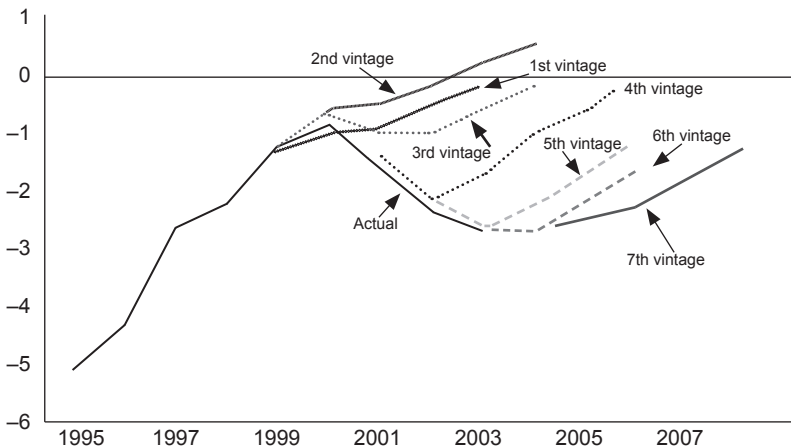
France and the Netherlands, it was clear that the adoption of the Constitution would have no significant implications beyond the recognition of the role of the Eurogroup, as the working group on this topic set up by the Convention could not agree on any meaningful change.

### *Fiscal Discipline at Work*

However, the ‘solid’ fiscal discipline pillar did not perform much better. The threat of sanctions did not lead governments to adopt prudent policies during the upswing and, after the slowdown in 2001, an increasing number of countries found themselves in excessive deficit. By 2003, three countries, including the two largest ones, Germany and France, were already subject to the excessive deficit procedure. By 2005, seven out of the 12 members of the euro area would have been confronted with the same procedure. While member countries had committed to having their public finances ‘close to balance or in surplus’, the aggregate public deficit of the euro area actually increased from 1.3 per cent in 1999 to 2.4 per cent in 2004 and aggregate public debt decreased only marginally, from 71.7 per cent to 70.8 per cent. Stability programmes were not anchors but proved to be moving targets (Figure 1). This was evidence that the Stability Pact had not succeeded in eliciting prudent fiscal management.

In fact, the most notable characteristic of fiscal policy since the launch of the euro has been a high degree of inertia. After the fiscal consolidation in 1995–97, the cyclically-adjusted deficit of the euro area has remained roughly constant. The SGP has thus not been effective enough to engineer a general

Figure 1: Aggregate Euro Area Budgetary Deficit: Stability Programmes v. Actual



Source: Commission (2006).

move towards fiscal balance, but it has been significant enough to prevent a reliance on discretionary fiscal stabilization as was the case in the US in the post-2000 period.

The Pact eventually became dysfunctional when it appeared in November 2003 that the Council would not necessarily impose sanctions on excessive deficit countries. For all the talks about the 'rules-based' character of the SGP, the Council had retained a significant dose of discretion in the implementation of the successive steps of the excessive deficit procedure. Only the Commission had in effect been deprived of discretion. Unsurprisingly, when the Council had to take a decision on the activation of another step in the procedure against Germany and France, a coalition was formed within the Council to suspend the procedure. Although the Court would eventually rule that it was not in the Council's power to put the application of the Pact in abeyance, the message was very clear: there was no such thing as an automatic implementation of the SGP.

The landmark decision of November 2003 opened the way for a reform of the Pact that would significantly alter its philosophy. While the focus of the initial SGP was on simple, quasi-automatic rules whose implementation did not require exercising judgement, the reformed Pact adopted in 2005 placed emphasis on economic assessment. The intention was to improve the incentives throughout the economic cycle and especially to make the preventive arm of the SGP effective – in order to prevent governments from making policy mistakes in good times; to differentiate the medium-term target by country, in order to take into account other variables than the headline deficit, especially the sustainability of public finances; and to take into consideration the content of policies rather than their effect on the deficit only (Commission, 2006).

About a year after they were adopted, the interpretation of those changes is still a matter for discussion. A widely held view among academics was that the Pact had simply been watered down and that it had lost almost all effectiveness (see, for example, Calmfors, 2005). However, from March 2005 to May 2006 the Council addressed notices and set deadlines for several euro area countries, including important ones such as Germany and Italy. Furthermore, there is evidence that those countries are taking action to redress their deficit. There is therefore no empirical basis for the claim that the Pact is dead.

The change is probably a more subtle, though profound one. While the Commission claims that the Pact remains rules based, it also acknowledges that its reform has 'moved the emphasis from a single indicator to a more reasoned analysis of the budgetary position of Member States' (Commission, 2006). This means that, instead of making a virtue of blindness, as at the time German Finance Minister Theo Waigel insisted that membership of the euro required respecting the '*Drei komma Null*' limit, the Commission and the Council need

to exercise judgement. The underlying intellectual model has thus shifted from obedience to a rule to what economists call 'constrained discretion', that is, the adoption of a framework for decisions which prevents arbitrariness and pure political choice through reliance on principles and indicators, while leaving room for case-by-case decisions (Bernanke and Mishkin, 1997).

If this is a correct reading of the evolution, there are significant implications for governance. The implementation of a fixed rule requires little more than a computer, but the implementation of a constrained discretion approach requires an effective policy institution. The Commission can certainly provide the expertise and make proposals to the Council. But at the end of the day, the new approach requires the Council to be able to implement it in a consistent way over time and across countries, without leaving decisions on individual cases at the mercy of political compromises – a very demanding call for a group formed of ministers.

### *The Eurogroup: From Semi-clandestinity to Half-light*

Simultaneously the Eurogroup has gradually strengthened and has transformed from a mere talking shop into what increasingly looks like a policy-making institution (Coeuré, 2002; Korkman, 2004). Although still deprived of formal powers, it has become a kind of caucus within the Council in which the important discussions, for example on the implementation of the Stability Pact, take place and lead to decisions that are thereafter endorsed by the wider Ecofin – an evolution that has accelerated since the enlargement. It is the place where the ministers and the ECB president meet and hold a dialogue on policy issues. Since January 2005, it has also been equipped with a fixed presidency – an important change with respect to the need to ensure time-consistency, and one which is in accordance with the move to a constrained discretion model.

The Eurogroup certainly does not have the formal authority of a euro area council. In fact, it still does not have any formal role (though the draft Constitution would have granted it formal recognition). But, in spite of these severe limitations and within a relatively short time span, it has become an important venue. In spite of the uncertain fate of the draft constitution, it is likely to acquire legal recognition in the years to come.

Summing up, the striking fact about the governance of the euro area is that, while its weak co-ordination pillar has not delivered more than expected, its strong discipline pillar has delivered less than expected. Furthermore, the model underpinning economic governance has evolved and the Eurogroup has become a significant policy body. Contrary to what could have been deduced from the assessment of the foundations of EMU, the jury is still out as regards the direction its governance will take.

## Conclusions

The question at the start of this article was why the controversy over the economic governance of EMU remains alive more than 15 years after the start of the discussions on the constitution of the single currency. In view of the relative weakness of the legal provisions that reflect the 'French' governance-by-co-ordination model and of the limited intellectual capital it could rely on, demands for some form of economic government could have been expected to evaporate gradually. Simultaneously, the internal intellectual consistency of the 'German' governance-by-rules model and the legal strength of the treaty provisions it could rely on should have led to its dominance.

This did not happen. By mid-2006, that is, more than six years after the launch of the euro, the economic governance of the area was still in balance. Why?

The explanation offered by this article is that in spite of its institutional and legal firepower, the governance-by-rules approach did not pass the test of reality. When confronted with the need to enforce the Stability Pact, ministers did not play by the rules they were supposed to implement in a blind manner. This destroyed the very notion that the governance of EMU need not rely on a decision-making institution.

At the same time, the basic tenet of the governance-by-co-ordination model, namely that a monetary union requires some form of co-operation on the economic side, remained alive in spite of its intellectual and legal weaknesses. Beyond disputed economic arguments in its favour, the case for it is essentially based on the political argument that monetary union cannot work properly without being supported by some form of economic union. The argument, however, is far from having been worked out in a consistent manner.

As a result, both the intellectual underpinnings and the institutional set-up of the governance of EMU are in need of repair. What the last few years have taught policy-makers is that none of the simple models they had in mind was up to the task. What remains to be seen is whether they are able to learn from this experience and develop step-by-step a reformed economic governance regime for the European currency area. This will be no easy task and beyond the necessary compromises, this will first and foremost require a substantial intellectual investment.

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