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The Functioning of Economic Policy Coordination

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I. Introduction

The beginning of Stage III of Economic and Monetary Union (EMU for short) has brought a qualitative change in the framework for economic policy making in the member states. The combination of the single currency and the Single Market creates a unified economic area in which national borders increasingly lose importance for the economic decisions of suppliers and consumers. At the same time, however, large parts of economic policy remain the domain of national or subnational policies. The increasing discrepancy between the European organization of private economic decisions and the national orientation of those parts of economic policy that are not directly regulated by the rules of EMU and the Single Market is the next, important challenge for the development of economic integration in Europe. The key question is, how national economic policies should be coordinated among themselves and with the single monetary policy of the ECB.

Economists have analyzed this issue from two perspectives. The first takes the organization of economic policies at the national level as given and asks, how much coordination of these national policies is necessary.[1] Coordination is interpreted as a process of (formal or informal) agreement among independent, national actors. From this perspective, coordination is the exception to the rule. Economic analysis of this process identifies conditions that justify the exception, focusing on the existence and magnitude of international “spill-overs” or policy externalities.

The alternative perspective takes the common economic area as the starting point of the analysis. Standing in the tradition of the economic theory of federalism, it starts from the assumption that, in an economic area characterized by trade and factor mobility, the activities of private economic agents and of economic policymakers are interdependent. Coordination is the process that makes these activities mutually consistent in equilibrium. Coordination is a matter of degree and ranges from competition among independent national or regional authorities to merging such authorities to a supranational one. In this view, whether or not economic policies should be coordinated in the EMU is not a sensible question, the proper question is what the best mechanism for coordination in a given field of economic policy is.

This is the perspective we pursue in this paper. In section 2, we develop our view in more detail, following a distinction between “club goods” and “national goods” in economic policy making in EMU. In section 3, we review the existing mechanisms for policy coordination in the EU and discuss the linkages between them and the club goods

[1] For simplicity, we abstract from the fact that subnational jurisdictions are also involved in the making economic policy.

of EMU. In section 4, we turn to the question whether the current framework for policy coordination promises a sound functioning of EMU. Section 5 concludes.

II. Principles of Policy Coordination

We distinguish two sources of interdependence between national economic policies in EMU, club goods and horizontal spill overs. The latter are the more conventional ones that have been dealt with in traditional literature. The first is the more innovative one and is characteristic for Stage III of EMU.

II.1. EMU Club Goods

We define EMU "club goods" to be economic variables that are shared among all member states.[2] The first club good is the largely unified, competitive market for goods, services, capital, and – to a lesser extent – labor. Additional club goods result from the fact that the members of the euro area share a single currency, a common central bank, and a common payment system. The price level of the euro area is such a club good. Since a common currency implies that the price level can reasonably be defined only for the entire currency area, it is obvious that all EMU members together enjoy price stability or suffer from the lack of it.[3] In the same vein, low currency risk (reflected in the common level of long-term interest rates), external balance (reflected in the level and variability of the exchange rate of the common currency against other currencies), and the stability of the EMU banking sector and financial markets (reflected in efficient and stable financial intermediation) are club goods whose benefits accrue to all member states simultaneously.

The importance of these club goods is best illustrated by an example. Starting from a macroeconomic equilibrium, assume that a large EMU member state adopts a tax policy that leads to a slow-down in economic growth and an increase in prices in this country, e.g., an increase in social security taxes. As a result, the euro-area price level moves upwards. The ECB will react to this change with an increase in its interest rate. By assumption, this change will upset the macro economic equilibria in the other EMU member states. Preserving the quality of the EMU club good price stability in the presence of national policy actions by one member creates economic costs for the other members.

The point of the example is that the existence of EMU club goods implies a new channel of externalities between national economic policies. Policies of individual member

[2] The classical analysis of the economics of club goods is Olson (1965).
[3] Note that individual countries can experience price developments that differ from the average inflation rate in the euro area. However, such differential developments must be properly interpreted as regional *relative price movements*, which can be expected to be temporary and which cannot be the subject of EMU monetary policy.

states that affect policy-relevant euro-area aggregates have economic implications for the other member states, because the ECB will react to them and this reaction is felt by all member states. Consequently, it is not enough to look at the direct transmission of policy impulses between countries, as the traditional literature on policy coordination has done in the past, to identify the need for cooperative policies in the euro area.

The existence of EMU club goods invites free-riding behavior and discourages policies that improve the quality of the club goods. Consider a situation of a persistent external deficit of the euro area, which would lead to a depreciation of the euro in the longer run. The external deficit calls for a fiscal contraction in the euro area to reduce aggregate demand. But which member state will take the appropriate steps and cut public expenditures? As each government has an incentive to wait for others to do so, the fiscal adjustment will come too late, if at all. As a result, there is not enough collective action to maintain the quality of the club good of external balance. Generally, governments in the euro area have weaker incentives to pursue policies improving the quality of the club goods than governments in national currency systems have with regard to national economic target variables, as the benefits from doing so fall partly on other governments in EMU.[4] As in other, more conventional contexts, the club good character of important economic variables in EMU implies that non-cooperative national economic policies do not yield efficient policy outcomes.

There are two basic channels through which national economic policies affect the EMU club goods. The first, obvious one is that some national policies directly affect the relevant euro area aggregates. As indicated in the example above, this is true for policies affecting the price level. Policies affecting the common exchange rate and external balance, and to the extent that the ECB takes euro-area wide economic growth and unemployment into consideration when setting its monetary policy, policies affecting these variables are also relevant here.[5] This regards primarily public spending and taxation, i.e. the macro economic policies of euro area governments. But note that this goes beyond budget deficits and public debts, the focus of the Stability and Growth Pact, as the level and the structure of public sector revenues and expenditures have important macro effects on growth, employment, and prices.

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[4] Recognition of this problem with regard to the level of public sector debts and deficits has been the justification for the Excessive Deficit Procedure of the Maastricht Treaty and the Stability and Growth Pact.

[5] Although the ECB's main goal is price stability, it has a wider mandate of pursuing the general economic policies in the community provided that price stability is not endangered. Furthermore, the policy statements of the ECB clearly reflect a concern with cyclical developments in the euro area.

The second channel works through national economic structures that shape the environment in which ECB monetary policy operates. For example, structural changes affecting the slope of the Phillips curve or the NAIRU in an individual euro area economy will change the constraints the ECB faces for its low-inflation policy. As the long-run equilibrium inflation rate of the euro area depends on such parameters[6], national economic policies affecting them will have an impact on the common inflation rate in the euro area. Again, the club good character of price stability in EMU implies reduced incentives for governments to undertake policies improving the structural environment of the single monetary policy, if such policies carry political or economic costs in the short run.[7] The implication is that policy coordination in the euro area does not naturally stop with macro economic policies (Jacquet and Pisani-Ferry, 2000), but includes structural policies that affect the performance and flexibility of European markets for goods, services, and labor.

One might suggest at this point that the EMU club goods call for cooperative policy making among the larger member states but not the small ones, as policies in the latter have negligible effects if any on the euro-area aggregates. But this conjecture is misleading in two ways. First, the adverse incentive effects are larger for the small countries than for the large ones precisely because the large ones can anticipate the consequences of their actions on euro-area aggregates and subsequent monetary policy reactions. Therefore, the larger countries will internalize these effects partly, though not fully. In contrast, the small countries will not anticipate any such effects and, therefore, have even weaker incentives to conduct policies preserving the quality of the euro-area club goods than the larger ones. Second, the small countries together make up about 25 percent of euro-area GDP, i.e., taken together they are not small. The implication is that one should not limit considerations of policy coordination to the large states.

The need for cooperative policymaking in the presence of important club goods has, of course, long been recognized in the context of the EU's first club good, the Internal Market order (Jacquet and Pisani-Ferry, 2000). Here, new cooperative policies are developed and proposed by the European Commission, and the proper implementation of the existing policies is monitored by the Commission and enforced by the European Court. Internal Market law and its implementation have replaced large parts of national legislation in the relevant areas in the member states. Furthermore, the process of monitoring and

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[6] This is the basic tenet of models of monetary policy based on credibility arguments. See e.g. Barro and Gordon (1983).

[7] See e.g. Sibert and Sutherland (1997), Calmfors (1998) and von Hagen (1999a and b). Saint-Paul and Bentolila, (2000) show that small reforms may find a higher political incentives within EMU, since the "There is no alternative" (TINA) strategy lowers the costs in the presence of shocks.

enforcing the high quality of the club goods involves private agents who have the right to take legal action against violations of the Internal Market order.

The framework for cooperative policy making with regard to the EMU club goods is much less developed today. Below, we review the existing policy mechanisms for this purpose. Here, we state a few principles. An important difference between the Internal Market and the EMU club goods is obviously that the former consists largely of legal rights and obligations for private individuals and private and public institutions, while the latter consist largely of macroeconomic developments. The difference is important, because the Internal Market club good is a traditional subject of public and private law. In contrast, economic variables such as "price stability" are difficult to define from a legal perspective, and the extent to which they are provided by the relevant institutions such as the ESCB is difficult to assess on a legal basis.[8] Even fervent advocates of monetary policy rules are unlikely to favor legally binding constraints on monetary policies, as this would leave the central bank unable to respond to macro economic shocks. The result would be an undesirable destabilization of output and employment in the euro area.[9] Thus, in the context of the EMU club goods, cooperative policies will have to rely on a framework that allows for a more flexible setting of policies.

In principle, cooperative policymaking can have a narrow or a broad agenda in this context. The narrow agenda would consist of monitoring the national economic policies of the EMU member states and vetoing policies that are expected to worsen the quality of the club good. The Excessive Deficit Procedure and the Stability and Growth Pact are examples for this. The main challenge here is to identify policies that might affect the club goods adversely and to dissuade member governments from adopting or continuing such policies. The broad, ambitious agenda would go beyond that and develop cooperative policies to improve the quality of the EMU club goods.[10]

II.2. Horizontal Spill-overs

Traditional analysis of international economic policy coordination focuses on horizontal spill-overs of economic policy between countries. Spill-overs arise when the policies adopted by one country have a direct effect on economic variables relevant for

[8] The question whether a central bank should be subject to a legal obligation to keep the rate of inflation below a certain number has been discussed extensively in the literature, e.g., in the context of the Reserve Act of New Zealand and the statutes of the ECB. See e.g. von Hagen (1997).

[9] See Fratianni, von Hagen, and Waller (1997) for an analysis of these issues.

[10] Kenen (1990) distinguishes between a 'policy optimizing approach' based on economic analysis and a 'regime preserving approach' which characterizes the practical attitude of governments. The latter is a no-conflict rule with the purpose of preventing conflicts between national economic policies and the club goods. The distinction corresponds to our concept of narrow and broad coordination.

economic policies in other countries. The focus of the argument is on national targets of economic policy of the individual member states. Thus, we may speak of “national goods” in contrast to “club goods”. Here, the transmission mechanisms are based primarily on quantity effects and international arbitrage. An example for the former is the rise in aggregate demand in one country due to the rise in another country’s demand for imports following, say, a fiscal expansion. An example for the latter is a rise in interest rates in one country following the rise in interest rates in another country due to interest rate parity. Spill-overs can be positive, as in the case of a fiscal expansion causing aggregate demand to go up in other countries, or negative, as in the case of a fiscal expansion causing interest rates to go up in other countries. Note that the existence and relevance of spill-overs does not hinge on the assumption that countries face similar shocks.

The literature has dealt extensively with such cases, primarily in a context of game theory (see Hamada and Kawai 1997; McKibbin 1997; and Milner 1997 for comprehensive reviews). The main idea is that failing to recognize the externalities implied by policy spill-overs leads to inefficient policy outcomes. Thus, horizontal spill-overs demand cooperative policymaking among the countries affected by the externalities.

The direction and intensity of such externalities among the euro-area countries is an empirical question.[11] Existing studies (e.g. in Buti and Sapir, 1998) typically find that horizontal spill-overs are too small and ambiguous to justify explicit policy coordination in EMU. However, such results are necessarily based on historical data and misleading, since monetary integration is likely to lead to new and stronger spill-overs. On the one hand, monetary integration should intensify trade integration and thus increase positive spill-overs. On the other hand, monetary integration has created a unified financial market in the euro area and, hence, increased international asset price linkages.

II.3. Elements of Cooperative Policymaking

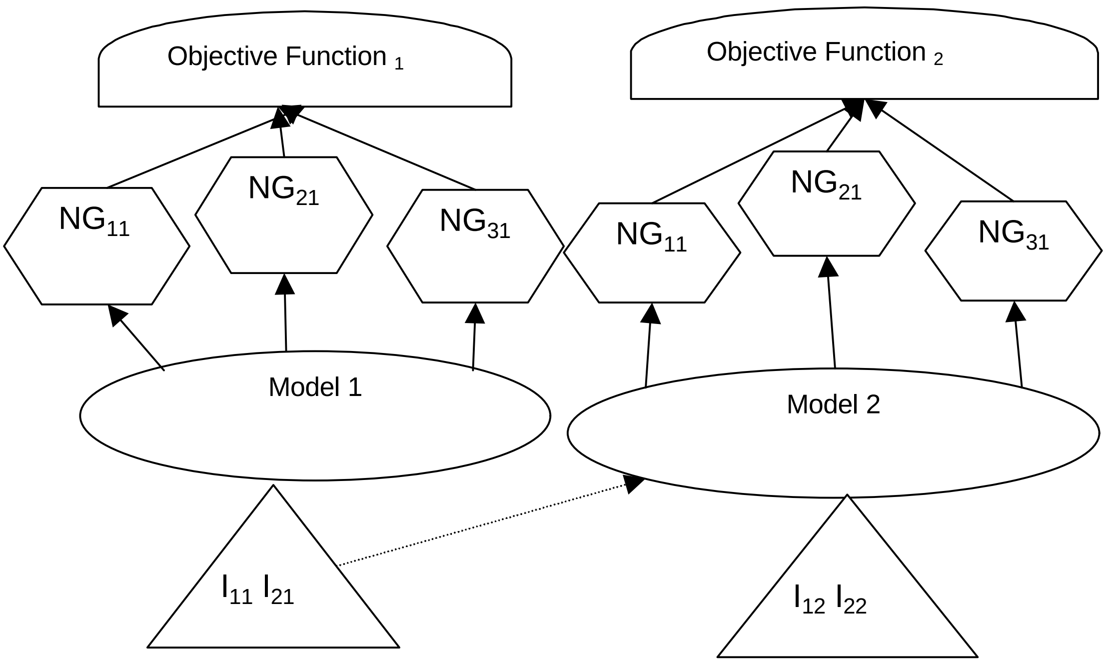
According to the Tinbergen paradigm, rational economic policy consists of the following elements: A set of policy goals, which are first expressed qualitatively (e.g., price stability) and then quantified in target levels (e.g., inflation rates below two percent annually), an objective function defined over these goals and the degree to which they are achieved, a set of instruments available to the policymaker allowing him to move the target variables close to the desired levels, and an economic model describing the links between

[11] McKibbin (1997) points out that empirical studies of international policy coordination typically find that the gains from cooperative policies are small. This result, however, comes mainly from comparing optimal cooperative with optimal non-cooperative policies and from considering policy settings with no uncertainty. Gains from cooperation can be larger if more simple policy rules are evaluated or uncertainty is taken into consideration.

instruments and goals as well as any trade-offs between the goals. Given these elements, an optimal policy is the solution of maximizing the objective function given the constraints described by the model.

Consider two countries, j=1,2, each pursuing rational economic policies to reach three linearly independent national policy goals[12], NG_{ij}, i = 1, 2, 3. Each government has a set of linearly independent policy instruments I_{kj} , k=1,…, n, available to achieve its goals. Each economy is described by a model linking instruments and objectives. Figure 1 illustrates the problem of policy coordination in the presence of horizontal spill-overs.

Figure 1: Policy Cooperation with Horizontal Spill-Overs



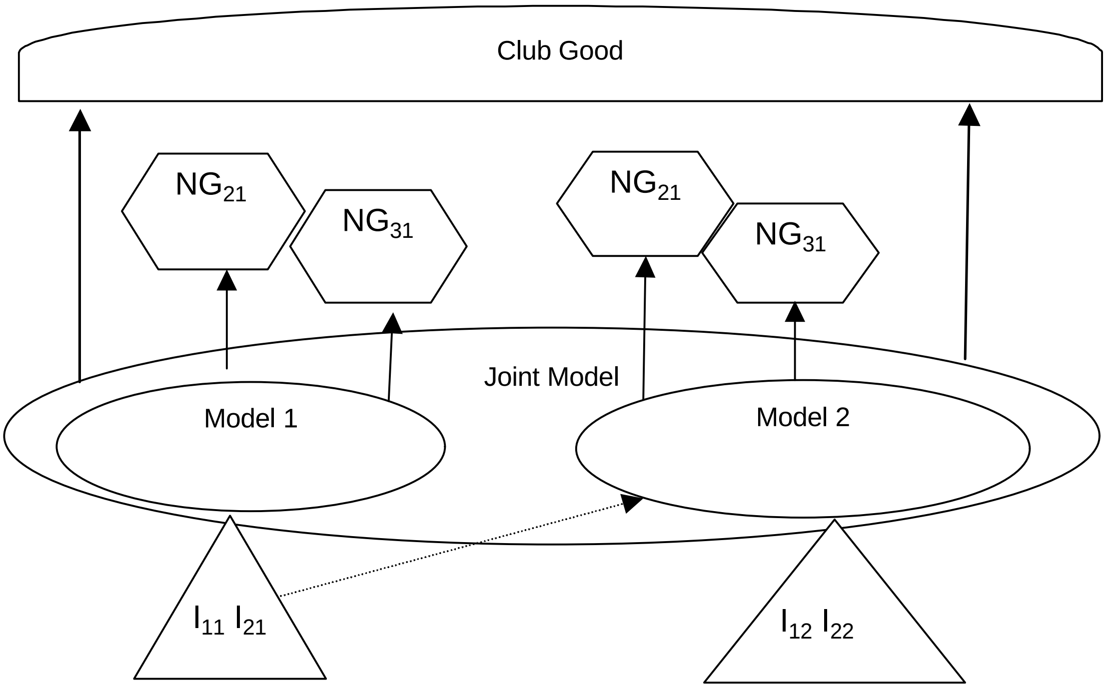
A first point to note here is the role of policy trade offs. If each government had n=3 independent instruments available, it would be able to achieve all three goals fully at the same time. Realistically, we assume that each government has only two instruments available, n=2. Consequently, policymaking involves trade-offs between the goals. Decision making then requires an objective function evaluating this tradeoff and indicating a most desired combination of instruments and levels of achievement in the three goals.

Figure 1 also shows that the policy instruments of country one have an impact on the goals of country two, a horizontal spill-over. Non-cooperative policymaking is, therefore, inefficient. This inefficiency can be overcome by setting policies cooperatively. Formally, this involves the optimization of the sum of the two objective functions.

[12] The linear independence assumption means that no pair of goals is perfectly correlated.

Consider now a situation where the two countries have formed a club and where the former goal variable i=1 has become the club good. This situation is described in figure 2. As indicated in the figure, the relevant model for the club economy is now an encompassing one that includes both of the national models. Policymaking in this setting is more complex for a number of reasons.

Figure 2: Policy Cooperation with Club Goods



Note, first, that policy making would be extremely simplified in this setting if the set of instruments available to each country had a certain property of separability. Specifically, assume that the combined instrument I_{1j} , j=1,2, affects only the first goal variable, such that all remaining policy trade-offs involve the second instrument and the other two goals. In this case, the countries might create a specialized club agency vested with the power to use the combined instruments to achieve the first policy goal. The national authorities would then be able to focus entirely on the remaining goals of national economic policy. Efficient policymaking would still require cooperative policies among the two countries to account for the horizontal spill-over. Importantly, however, there would not be a trade-off to be considered in reaching the desired level of the club good and the desired levels of the national goal variables. That is, the club authority could be committed entirely to a full achievement of the first policy goal with no need to evaluate any choices between different degrees of achieving this and the remaining policy goals at the national level. But note that this separability would hold before the formation of the club already. That is, one should be able to observe that both countries fully reach the first policy goal before the formation of the club.

This separability is obviously important in the case of EMU. Here, the club agency is the ECB, which the mandate to pursue price stability as its principal goal without regard to any other variables. Only if price stability has been achieved, the ECB is allowed - and required – to consider other policy goals. As we will see below, a framework for cooperative policymaking among the ECB and the national governments has not yet been developed. Thus, the current setup of the EMU seems to rely on the assumption that a separability of the kind described here holds in the euro area (Padoa-Schioppa,1999). But the fact that price stability was not always achieved before EMU, and that national monetary authorities formulated their policies in a context of trade-offs between price stability, unemployment and output growth suggests that the assumption of separability between monetary policy and other policy instruments available to target the remaining goals of economic policy is questionable in practice. If the separability between policies does not hold in the way described above, the setting of national economic policies in the club becomes more difficult. The reason is that the economic constraints given by the model of the club and the national economies imply a conflict potential between the national authorities. [13]

A first approach to deal with this conflict potential is to define a joint objective function over the club good and the national policy goals. The joint objective function would make the two governments' valuation of different degrees of achieving the policy goals explicit and, therefore, its construction would require a political bargaining process. Optimization of this joint objective function would then yield optimal values for all national policy instruments (and the instruments of a club authority, if it exists.) This optimization would simultaneously solve the horizontal externality problem. [14]

A second approach is to give the club good preeminence over all other goals of economic policy and require full achievement of the associated goal regardless of the achievements in other policy dimensions. As in the case of the ECB, this preeminence could be institutionally underpinned by creating a special club agency vested with sufficient instruments to achieve this goal and independent from the national governments. Its independence would assure that the club agency would pay no attention to other policy

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[13] The existence of such a conflict potential has been recognized by the Luxembourg Council in 1997 which concluded that "…To the extent that national economic developments have an impact on inflation prospects in the euro area, they will influence monetary conditions in that area. It is for this basic reason that the move to a single currency will require closer Community surveillance and coordination of economic policies among euro-area Member States."

goals unless the first goal had been fully achieved. Such an approach appears attractive at first glance, because it does not seem to require a political agreement regarding the valuation of trade-offs between the club- good and the national policy goals.

Preeminence of the club good, however, only moves the conflict potential between the national policy goals and the club good to a different level. To illustrate this, assume that the first government, because of a large negative shock to its target variable NG_{21} wants to increase the use of instrument I_{21} and that this has a damaging effect on the club good. Suppose that maintaining the desired level of the club good requires either a reduction of the second government's use of instrument I_{22} or a response by the club authority that affects both countries negatively. There are now three outcomes: (1) The first government renounces the use of I_{21} and, thus, implicitly accepts a lower degree of achieving NG_{21}. (2) The first government increases the use of I_{21} and the second government reduces the use of this instrument, i.e., it implicitly accepts a lower degree of achieving NG_{22} . (3) The first government increases the use of I_{21} , the second government does not react, but the club authority does, causing a lower degree of achieving the other policy goals in both countries. Any choice between these three outcomes (or convex combinations of them) involves a judgment of the fair distribution of "welfare" among the two countries. This is equivalent to optimizing a joint objective function defined over the policy goals of both countries that takes a full achievement of the goal connected with the club good as given. The outcome of such an optimization would be less efficient than that of optimizing a joint welfare function, as it amounts to a constraint optimization. As long as there is a non-zero correlation between the club good and the national policy goals, judgements regarding the implied trade-offs or the distribution of costs across the club members cannot be avoided.

The analysis so far has assumed that the club provides only one club good. Above, we have identified several club goods in the context of the EMU. The existence of several such goods further complicates the situation, as trade-offs between these club goods must be considered in addition to the trade-offs between them and the national economic policy goals. One implication is that the approach of giving one club good preeminence over all other goals of economic policy will only work if the provision of all club goods is strongly positively correlated. A related implication is that the creation of a single club agency charged with the provision of the first club good will not guarantee a satisfactory provision of the other club goods. In the context of macroeconomic policies, this is the well-known problem of the policy-mix (Jacquet and Pisani-Ferry, 2000). One way out of this dilemma

[14] Dixit and Lambertini (2000) provide a simple model of the Barro Gordon type for horizontal externalities that allows also for some sort of monetary and fiscal policy interactions using two

would be to charge the club agency with the task of providing all club goods in satisfactory quantities. But this would require the club agency to evaluate trade-offs between them and make choices accordingly; a task that would be too demanding for an independent agency. Thus cooperative policymaking is required among the members to assure a satisfactory performance of the club.

The essence of this discussion is that cooperative policymaking in the context of a club good requires a decision making framework that contains the following elements:

- A framework of analysis (a model) linking policy instruments and policy goals at the national level and the level of the club;
- A framework for evaluating the degree of achievement of policy goals and for evaluating trade-offs among them (an objective function);
- A procedure for deriving optimal instrument values at the national and the club level (a collective choice mechanism).

One might object to this analysis that it relies too much on optimizing economic policies, an unrealistic assumption in practice. The literature on cooperative policymaking, however, has shown that the gains from cooperation are even larger when governments follow policy rules that are simpler than those implied by full optimization (McKibbin, 1997, von Hagen, 1993). Importantly, the conflict potential implied by trade-offs between the club good and national policy goals is not removed by simplifying economic policies.

What, if the club members cannot agree on such procedures? In the absence of a club agency charged with producing and maintaining the club good, this would lead to permanent underprovision of the latter. The result would be a poor performance of the club that would undermine its stability. Thus, the creation of a club agency is an essential step in setting up a club with no or little cooperative policymaking. But note that this suffices only in the presence of a single club good. With multiple club goods, underprovision of some of them would still be the consequence.

With a club agency, the club would enjoy a high level of provision of the club good, but this might come with more or less unsatisfactory degrees of achievement regarding the national goals of economic policy. Each member state would optimize its economic policies given the level of club good provision delivered by the club agency, and each member would have to accept that it could not do any better than that. This could well be an acceptable outcome as long as no individual member engages in policies that impinge heavily on the club good and force the club agency to react in ways inflicting significant costs on the other members. Thus, even in the absence of cooperative policymaking, the

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policy objective functions with different weights for the goals for ECB and national authorities.

functioning of the club requires mechanisms of "narrow cooperation", i.e., rules that prevent club members from imposing economic costs on others.

Furthermore, individual club members in such a scenario have incentives to engage in structural policies – changing properties of their economies reflected in the parameters of the economic models – that improve the outcomes of their policies with regard to their national policy goals given the provision of the club good by the club agency. In fact, this is often regarded as an attractive aspect of such a scenario, as the lack of cooperative policymaking would create competition among the members and this competition would improve the performance of the national economies.[15] Ex ante, however, it is not at all clear what such reforms would imply for the ability of the club agency to deliver the club good. Again, a framework of "narrow cooperation" would be required to prevent such developments.

The situation would be more difficult, if a member state were hit by a large shock, the adjustment to which had significant adverse consequences for the other members, while not adjusting to it was politically and economically very costly and would call the country's club membership in question. Some cooperative action would then be required. While this suggests that one could leave cooperative policymaking to times of crises, it would still be necessary to develop a framework for exceptional cooperation that would contain all the elements mentioned above and a mechanism for identifying and declaring crisis.

Individual rationality suggests that no member would have joined the club expecting this outcome to be worse than staying outside the club. Thus, although the absence of cooperative policymaking yields worse results than cooperative policymaking, it should still be better than not forming the club at all, and it should be viable in normal times, i.e., the absence of large shocks. Still, the power of the reference point of staying outside the club is likely to vanish as the club grows older. Over time, therefore, it is likely that the demand for more cooperative policymaking increases.

III. Mechanisms for Policy Coordination in the EU

The purpose of the following section is to describe the existing processes of policy coordination. We discuss how they relate to each other and in what ways they differ. We then identify obstacles in the present EU network of coordination procedures with respect to existing club goods.

[15] As shown by Oates and Schwab (1988) and Sinn (1997), however, the analogy of competition on private markets and competition among governments is not as simple as the popular argument suggests.

Prior to the start of monetary integration, policy coordination in the EU was based on two main methods, harmonization of policies based on common rules of behavior and delegation to Community institutions (Jacquet and Pisani-Ferry, 2000). The administration of the Internal Market and Common Agricultural Policy are prime examples for delegation, where the authority over common policies was given to Community institutions. The coordination of monetary policies within the European Monetary System was an example for rule-based coordination among national authorities. EMU has added further examples of coordination based on these methods. The conduct of the single monetary policy by the ECB is an obvious 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. But in addition to these traditional methods of coordination, the Maastricht Process and the development of the Union during the 1990s have introduced new ones that are based on dialogue, the exchange of information, peer pressure and persuasion.

III.1. Actors

According to the Treaty (Art. 99), member states coordinate their economic policies at the EU level within the Council of Ministers with the participation of all 15 member states and the presence of the European Commission and the ECB where deemed necessary. The Council of Economics and Finance Ministers (ECOFIN) is the relevant one for the discussion and decisions about government deficits, spending, and taxation, while the Employment/Social Affairs Council deals with employment and social policies. In the coordination procedure established by the Treaty (Art. 99), the Council adopts policy guidelines and recommendations by majority voting on a proposal from the Commission, thereby following the conclusions of the European Council - the Heads of State or Government of the 15 member states and the highest level of coordination. Although the title of ECOFIN suggests otherwise, it is noteworthy that the members of this body are far from being a homogeneous group, as the functional and the political role of finance ministers varies considerably across EU member states.

The 1997 European Council in Luxembourg agreed to the establishment of the Euro group, now known as the Euro12-Group, of the finance ministers of the EMU member states, in recognition of the specific coordination requirements among participants of the euro area. Since the Euro Group has no legislative responsibility, its role is to assess the economic situation and to discuss the major policy issues for the euro area. It is chaired by a minister of a participating EMU member state, including in periods when the EU presidency is held by a non-EMU member. This subgroup of ECOFIN gathers in connection with ECOFIN meetings.

The European Commission is present both at ECOFIN and Euro12 meetings. The Commission has the right for initiatives in Council meetings and to provide analysis for multilateral surveillance. The Economic and Financial Committee (EFC) has advisory and preparatory functions for the Council meetings. It consists of representatives of national administrations and national central banks, as well as two representatives of the European Commission and the ECB. Within the limits set by the consensus agreements of the national governments, both institutions, the EFC and the European Commission have played leading roles in the development of the coordination process, e.g. by proposing the various procedures reviewed below. While the European Commission and the EFC cover macroeconomic and financial issues, the Economic Policy Committee (EPC), which consists of officials from economics ministries, concentrates on structural policies.[16]

According to insider views, the European Council and ECOFIN can hardly be regarded as effective institutions for cooperative decision making. Padoa Schioppa (1999) argues that ECOFIN is too large of a forum to develop concrete policy actions or policy rules. Furthermore, it involves too many participants and catches too much media attention to facilitate confidential discussions and deliberations.[17] The more informal Euro12-Group allows a more concentrated debate, since national delegations are restricted to two persons. However its role is limited since decisions can be taken only at the Council level. Jacquet and Pisani-Ferry (2000) argue that the Euro12-Group has played a useful role in developing the quality of economic policy debates among its members, but that the role of this group is largely exhausted with this function.

Art. 113 forms the Treaty basis for a dialogue between the Council and the ECB. It foresees the participation of the ECB in Council meetings where matters relating to monetary policy are discussed. In turn, the Council president has the right to participate in meetings of the ECB Governing Council and to submit motions for deliberation by the Governing Council. But since the president of the EU Council represents all members of the EU, he is not necessarily a good counterpart for the ECB to discuss the policy mix in the euro area. This is partly recognized by the practice that, if the EU presidency falls on a non-euro state, the Council president is represented by the chairman of the euro group, i.e. the finance minister from the next EMU member state to hold the EU presidency. The ECB president is always invited to participate in meetings of the Euro12 -Group.

In a study based on surveys of the national central banks and finance ministries, Bini-Smaghi (2000) finds that the quality and frequency of the dialogue between Council

[16] Under to the Lisbon strategy, structural policies should gain more prominence on the policy agenda.

and ECB are lower compared to the dialogues between the national finance ministries and the central banks before the start of EMU. As long as national finance ministries regard their policy as a matter of national concern, the reduced information exchange reduces the incentive to internalize the ECB's reaction and therefore leads to insufficient coordination.

Table 1: The annual EU Procedures and actors involved

Procedures	Form of Coordination and Instruments	Actors	Tasks
Broad Economic Policy Guidelines (Art 99 Amsterdam Treaty)	Core of economic policy coordination within the EU defining common objectives Annual guidelines and recommendations to member states	Council (EU11 Group) European Commission Member States	The BEPGs defines the economic policy orientations for the EU in accordance with Art 2. The BEPG integrate the different processes mentioned below.
Multilateral surveillance (Art 99 (3) Amsterdam Treaty))	Monitoring process Peer review	Council European Commission Member States	The Process monitors and assesses the economic developments and policies in Member States as well as in the Community as a whole. It forms the basis for Community compliance procedure (art 99 (4))
Excessive Deficit Procedure (EDP) **(**Art 104) **Stability and Growth Pact (SGP)** Regulation 1467/97	Common rules and objectives - Budgetary Surveillance - Pecuniary sanctions MS submit annually stability or convergence programmes	European Council European Parliament National Governments (Finance Ministries) European Commission	The EDP and SGP represent an obligation on Member States to achieve medium-term budgetary positions close to balance or in surplus. .
Cologne Process ECOFIN 1999	Informal macroeconomic dialogue at Community level - Informal exchange of view - 2 meetings per year	- ECB (+ representative of non EMU CB) -European Commission -Troika of current, subsequent and preceding presidency of ECOFIN and Labor/Social ministers Social Partners	The Cologne Process aims at improving the interaction between wage developments and monetary, budgetary and fiscal policy at the EU level. The Process was installed to complete the Cardiff and Luxembourg process.
Luxembourg Process (Art 128 Amsterdam Treaty)	Open coordination \Guidelines and recommendations to member states) Peer review Benchmarking, best practices pecuniary incentives (ESF)for MS to provide high quality information MS submit annually National Action Plans	European Council European Commission National Governments (Labour and Finance Ministries)	The Luxembourg process coordinates the European Employment Strategy. The purpose is to improve the effectiveness of national employment and labour market policies by better focusing on respective problem groups, improving the set of instruments and establishing a continuous evaluation process.
Cardiff Process ECOFIN 1998	Monitoring process within the Single Market - Identification of good practice - Peer review	European Commission Economic Policy Committee Nat. Gov (Econ + Fin Min.)	The Cardiff process is a multilateral review of economic reforms in product, capital and labour markets. The purpose is to improve the market efficiency of Member States' economies so as to enhance the favourable environment for growth, high employment and social cohesion.

[17] Italianer (1999) states that because of the abundance of accompanying officials the focus of attention has shifted towards the twice yearly informal meetings of ministers of finance and central bank governors which often managed to give decisive political impulses to the EMU process.

III.2. Processes

Table 1 presents an overview of the processes of policy coordination in the context of EMU. They include the Broad Economic Policy Guidelines, the process of multilateral surveillance, the Excessive Deficit Procedure and the Stability and Growth Pact, the Luxembourg, the Cologne, and the Cardiff process.

III.2.1. The Broad Economic Policy Guidelines

The Broad Economic Policy Guidelines (BEPGs) form the center of economic policy coordination process at the Community level in accordance with Art. 99 of the Treaty. The BEPGs consolidate the different existing processes (Luxembourg, Cologne and Cardiff, see below) and aim at exploiting the synergies between them. BEPGs also form the reference for the multilateral surveillance procedure, under which the consistency of national economic policies with the BEPGs and the functioning of EMU in general are monitored. The multilateral surveillance procedure includes the possibility to make confidential or public assessments of the policies of individual member states and to give confidential or public recommendations to their governments. The European Council decides by unanimity vote on the BEPG upon proposals by the European Commission and recommendations by ECOFIN.

The BEPG do not sufficiently recognize the existence of club goods in the euro-area that are not shared by non-EMU members of the EU. Thus, they do not constitute a proper framework for developing the macroeconomic policies to be adopted by the EMU member states to secure a proper policy mix. When the European Commission considered EMU matters explicitly in the BEPG 2000, Council ministers including some EMU members objected that distinction. When the BEPG for 2001 did not distinguish between EU and EMU in its analysis, some of the same Council members claimed that such a distinction would have been useful. This example suggests that the process of policy coordination is still in flux.

In the BEPG for 1998, 1999 and 2000 responsibility with respect to the club good 'price stability' was assigned not only to monetary policy but also to national fiscal policy by recommending that countries in which inflationary pressures were building up (Ireland, Spain and Portugal) should rely on fiscal policy to avoid overheating. Moreover, the BEPG include recommendations for the behavior of the social partners. It is unclear, however, whether or not the bodies developing and discussing the BEPG can make commitments on behalf of the social partners in the member states and secure the implementation of this part of the guidelines at the national level.

III.2.2. Procedures for the Control of Fiscal Deficits and Debts

Fiscal policy remains a national competence for EMU member states, but under several constraints. EMU Procedures for the conduct of fiscal policy are the Excessive Deficit Procedure (EDP), the Mutual Surveillance Procedure (Art. 99, 100, 111 TEU), the Stability and Growth Pact (Regulation 1467/97). The No-Bail-Out-Rule (Art. 103 TEU, Art. 21 ESCB Protocol) protects member states from becoming responsible for financial liabilities of other member states against their will. The Excessive Deficit Procedure includes the mandate (Art 3 of the Protocol) that the member states of EMU should implement appropriate institutions at the national level that enable them to fulfill their obligation to maintain sustainable finance. In contrast to the obligation for all member states to have independent central banks, there is, however, no explanation of what this obligation means in practice.For members of the EMU, the EDP is an unconditional obligation to avoid excessive deficits. In addition, the SGP calls for medium-term budgetary positions close to balance or in surplus. The higher the debt-to-GDP ratios of the country, the greater must be their efforts to reduce them rapidly. Member states are required to take immediate corrective actions, if they are found to have an excessive deficit. The EDP and the SGP allow for the imposition of financial sanctions in such cases – a feature that distinguishes these from other coordination procedures.

In this context, EMU members are required to produce annual Stability programs that present the main fiscal decisions and budgetary choices on the path to the medium term objective for budgetary positions close to balance or in surplus (2001-2004 for the latest programmes). The Council considers whether the budget-policy strategy and the economic targets continue to meet the requirements of the SGP and the BEPG. In order to prevent the occurrence of excessive deficits, the Council may give an early warning in line with Article 99(4) of the Treaty.

While the combination of the EDP and the SGP acknowledge the importance of fiscal discipline for the conduct of monetary policy, it is still unsatisfactory with respect to the EMU club goods for several reasons.

- First, the procedure focuses on individual member country performance with no regard to the aggregate fiscal policy stance of the euro area as a whole. Implicitly, it is based on the assumption that being close to balance is unconditionally the proper contribution of fiscal policy to macroeconomic stability in the euro area. While this may be true in the long run, conventional macroeconomics hold that stability demands different constellations of monetary and fiscal policy at different stages of the business cycle.
- Second, it focuses narrowly on deficits and debts and ignores the policies that affect the common exchange rate and external balance as well as the contribution

of fiscal policies to growth, employment and prices, such as the level and structure of public spending and taxation. In the context of policy coordination, the emphasis of the EDP and SGP on government borrowing is justified only if one assumes that national fiscal policies affect the EMU club goods and cause horizontal spill-overs predominantly through their capital market effects.

- Third, the EDP and SGP are designed to prevent countries from running excessive deficits that are defined in terms of fixed, numerical thresholds. No guidance is provided, however, for the member countries' fiscal policies in times when the numerical limits have been achieved. There is now ample evidence showing that problems with non sustainable public finances are typically the result of policies that allow a small number of spending items to run out of control (e.g. Perotti, Strauch and von Hagen, 1998). The recent reemergence of fiscal laxity in the EMU member states (see von Hagen, Hughes-Hallett and Strauch 2000) is consistent with that experience. It suggests that the rules for fiscal policy do not do enough to guide fiscal choices in good times and prevent the emergence of excessive deficits.

Within the existing framework for policy coordination, the place for formulating and monitoring the achievement of such objectives would be the BEPG. It is interesting, therefore, to note that the Commission's and the Council's recent recommendations for more fiscal discipline in Ireland were made under Art 99.4 (BEPG), although the analysis was made in the context of the SGP (Fisher and Reitano, 2001). Thus, there seems to be some recognition of the incompleteness of the framework for fiscal policy coordination provided by the EDP and the SGP. But the weaknesses of the BEPG for policy coordination in the EMU context also suggest that the potential for using them for the purposes indicated above is limited.

III.2.3. The Cologne Process

Under German Presidency, an informal macroeconomic dialogue known as the Cologne Process was introduced. It institutionalized a bi-annual informal process of consultations between public authorities and representatives of wage bargainers without setting objectives. The dialogue discusses technical macroeconomic issues on a national level and reports them subsequently for a political exchange between the ECB, ECOFIN, the Labor and Social Affairs Councils, the Commission, and the social partners. ECOFIN is represented by the 'troika' of the past, current, and subsequent presidencies. The social partners are represented by their respective organizations at the European level.

The Cologne Process aims at improving the interaction between wage developments and monetary, budgetary and fiscal policies in order to achieve stronger growth and higher employment while maintaining price stability. Although the dialogue explicitly considers the necessity of wage policies at the national level to be consistent with the EMU club good of price stability, the forum is unlikely to play a major role in the coordination process. This is due to the fact that the EU federations of trade unions and employers unions do not have the authority to represent a common view of the respective partners in all the different member countries and, therefore, cannot assure the enforcement of any agreements on guidelines for wage policies at the national level. This, in turn, is due to the institutional heterogeneity of social partner organizations in the member countries (See OECD ,1996).[18] There is nevertheless a role for improving the information content for fiscal, monetary and wage policy making in the presence of common price level as our club good.[19]

III.2.4. The Cardiff and Luxembourg Processes

According to a popular view, EMU membership should increase the willingness of governments to undertake politically inconvenient reform policies, as this is the only remaining policy tool to deal with asymmetric shocks. However, Sibert and Sutherland (1997), and Calmfors (1998) argue that reform incentives for member states can be less than outside EMU, as monetary policy no longer eases costly reforms in the national context and the benefit of one country's reform will be spread to all members of the euro area. In light of these arguments, the Luxemburg and Cardiff processes may be seen as attempts to reinforce reform incentives for member states via peer pressure. In addition, the two processes aim at improving employment and the functioning of the Single Market.

The Cardiff process monitors structural reforms and innovations of member states in product, capital and labor markets. In this process the Economic Policy Committee plays a leading role as it conducts a multilateral surveillance (Synthesis Report). Instruments used are peer pressure and an extensive reporting, monitoring and evaluation system. In accordance with the Lisbon strategy, more emphasis has been put on the identification of best practices. The Cardiff Process is now linked to the Single Market Report. Its relies on the concept of competition between different jurisdictions and aims at abolishing barriers to the free movement of goods, services, capital and labor. In 2000, quantitative indicators were developed by the Commission to improve the assessment in this area.

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[18] Wyplosz (1999) argues that further centralization at EU level is also hindered by the diverging labour costs throughout Europe where in Germany labour costs are five times larger than in Portugal.
[19] Collignon (2001) emphasizes that the underlying philosophy of the Macroeconomic Dialogue is to structure a debate in Europe where relevant policy information could be shared in a consensus building way.

The Luxembourg process was launched at the end of 1997 and reinforced by the inclusion of the Employment Chapter (Title VIII) in the Amsterdam Treaty.[20] The Luxembourg process aims at building a coherent approach to actively dealing with structural labor market problems in EU countries. The purpose is to improve the effectiveness of national employment and labor market policies by better focusing on problem groups, by improving the set of instruments, and by establishing a continuous evaluation process. The four 'pillars' and 22 'guidelines' serve to guide labor market and employment policies and as a basis for the assessment of country activities.

The Treaty sets up a framework for an annual multilateral surveillance procedure similar to the multilateral surveillance procedure of Art. 99 and in some aspects goes even further than that by giving the Council the possibility to adopt incentive measures. Specifically, the disbursement of monies from the European Social Fund has been made conditional on the member states' compliance with the Luxembourg process.

Even a short glance reveals a lack of substantial foundation of the pillars and guidelines of the Luxembourg Process. For example, the employment benefit from active labor market policies comes from addressing specific market failures. They can improve overall employment performance, if they are targeted specifically at individual market failures. Therefore, policies cannot be simply translated from one country to another, an implication, which is not explicitly considered in the current evaluation process. These fundamental weaknesses probably reflect a more basic problem of the Luxembourg process, i.e., the absence of a truly European employment problem. A review of the individual labor market performances shows that some countries have achieved full employment, while others have not. Among the latter, some countries have predominantly regional unemployment problems (Italy and Germany), while others have problems with specific social groups, which may be age-related (youth unemployment in France) or skill related (e.g., in the UK).

The practical experience with the process so far has shown that monitoring labor market policies across countries is not an easy task. The Luxembourg process demands a common evaluation of the 'input' and 'output' of active labor market policies. The definition and use of common indicators is complicated by the prevalence of different statistical conventions and different institutional settings which imply that the same indicator can mean very different things in different countries.

[20] The Treaty recognizes that member states retain the principal responsibility for employment policies. Nevertheless, Art. 125 calls for the development of a coordinated employment strategy by the member states and the Community, and Art. 126 calls upon the member states to contribute to the objectives of this strategy through their employment policies, to regard promoting employment as a matter of common concern, and to coordinate their actions in this regard.

As a result, the impact of Luxemburg Process for its main objective employment creation is less clear given different structural problems of the member countries. The process may nevertheless have an impact on reform incentives of member states and therefore affect the EMU club good. However, the main actors involved in the process are the Ministers of Labour and Social partners who may not account for the implications of their choices for the quality of club goods in this context. Thus, the process accounts insufficiently for the interaction between labor market policy and other policies.

IV. Effectiveness of Policy Coordination

In this section, we go back to our analysis to assess the effectiveness of these procedures in light of the exigencies for coordination in EMU. Several criteria can be derived from our analysis: the scope of cooperative policymaking in the EMU, the ability to face trade-offs and make choices between relevant policy alternatives, the ability to commit policies at the national level, and the quality of the analysis within the processes.

IV.1. Scope of Cooperative Policies

Our review of the existing procedures at the EU level shows that the scope of cooperative policymaking is broad even today, much broader in fact than a traditional reading of the concept of economic policy coordination in the EU context would lead one to expect.[21] The policies covered by the existing processes range from budgetary policies over labor market policies to regulatory policies at the national level. This is consistent with our view that cooperative policymaking should include policies that affect the environment and the constraints of the common monetary policy in EMU. Still, the existing procedures do not cover all relevant aspects of the broader policies involved, as in the case of the level and structure of public spending, although the Commission makes visible efforts to broaden the assessment of public finances in this regard (e.g. Commission, 2000).[22]

Nevertheless, there are significant limitations of the scope of cooperative policymaking. A first one is the fact that the existing procedures do not address all the different club goods of the EMU explicitly. A partial exception is exchange rate policy, which is at the center of the coordination between monetary and fiscal policies. Art. 111 TEU foresees that the EMU members of ECOFIN can decide, by qualified majority, following a recommendation of the ECB or the European Commission, and if price stability

[21] As discussed in Harden and von Hagen (1997), the term 'economic policy' has traditionally been interpreted to mean mainly budgetary policy.

is not endangered, on general exchange rate policy orientations. This creates an opportunity for cooperative exchange rate policies, albeit outside the ordinary processes described above. However, clear rules and procedures for such cooperation in case of reduced quality of the club good – exchange rate stability or misalignments - are missing. A viable alternative would be a framework that would allow the Council to respond to signals coming from the exchange markets on the basis of an analysis of the Commission and the ECB (Jaquet and Pisani Ferry, 2000). For the current-account club good no provisions are foreseen in the Treaty, although the Treaty has provisions for Community assistance in the case of an individual member country facing severe external imbalances. Similarly, the current processes pay no attention to the club good of financial market stability.

Another, significant limitation in the scope of cooperative policymaking is that the current procedures focus entirely on *ex-ante* coordination. That is, the participating countries (and the ECB, where applicable), reveal what they intend to do given their expectations about future economic circumstances. What will happen, if these expectations fail to materialize, however, is not part of the various procedures. This limitation is particularly important in the context of coordination between monetary and fiscal policy in the EMU, where the development of transparent rules for cooperative reactions to shocks could greatly help guide private sector expectations, which in turn largely determine the outcomes of macroeconomic policies.

IV.2. Ability to Face Trade-offs and Make Relevant Choices

Above, we have shown that EMU creates the need for formulating trade-offs between its club goods and between these and the national goals of economic policy. The current procedures for cooperative policies do neither make room for that nor for making the relevant choices. On the one hand, the processes are rather compartmentalized in terms of policy fields, while the analysis and evaluation of trade-offs requires dealing with more than one field of policy at a time. On the other hand, such an analysis and discussion currently only happens in the context of the BEPG. Yet, the specificity of the BEPG and the analysis surrounding them generally seems rather low (Pisany Ferry, 2001). For reasons stated above, the EU Council, the relevant decision making body in this context, does not seem to be the appropriate body for a detailed assessment of trade-offs and policy choices.

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[22] The Lisbon Council has asked the Commission to develop a concept of “Quality of Public Finances” as a broader framework and to evaluate the connection between public finances and economic growth.

The difference between EU and EMU matters particularly in this regard. At the level of the EU, the Internal Market constitutes the principal club good. As in pre-EMU times, the coordination of economic policies is deemed important in this context to assure that countries do not engage in policies that undermine the smooth functioning of the Internal Market – competitive devaluations being the traditional example. The euro area, however, has a broader need for policy coordination. Fears among the non-EMU members of the EU, that closer and more intensive policy coordination among the EMU states might have adverse consequences for their own competitive positions in the Internal Market have, so far, been an obstacle to the design of more effective processes.

The lack of a practical equivalent of what economists call an objective function of economic policy leaves the process of policy coordination in a vulnerable and risky state. It implies that there is neither a framework nor a forum to discuss in depth and detail choices between different degrees of achievement of different policy goals at the EMU and the national level and the distribution of costs of policy adjustment at the national level to achieve a good overall performance of the EMU. The implicit assumption of this setup seems to be that a competitive process of policy coordination, i.e., one in which each country does all it can to pursue its own goals at the national level given a common monetary policy and the Excessive Deficit Procedure, serves to guarantee the best performance of the EMU under all circumstances. There are good reasons to believe that this assumption is incorrect.

Elsewhere, we have argued that the quality of economic policy in the EMU could be greatly improved by the creation of an *Economic Policy Council*, an improved version of the Euro Group. With an appropriate institutional design, such a council would enhance policy coordination by developing judgments about policy trade-offs and the distribution of adjustment costs. It would be a significant step to overcome one of the most critical shortcomings of the current framework for economic policymaking in EMU.

IV.3. Ability to Commit

Effective policy coordination requires the possibility to commit the participants to some joint program of action or common policies. However, the current set-up for cooperative policies in the EMU relies essentially on peer pressure and persuasion. This is a direct result of the fact that the EMU member states were unwilling to give up further sovereignty over their economic policies or a lack of consensus (Collignon, 2001).

Experience with this approach in the EMU and in other contexts suggests that the responsiveness of governments to peer pressure is not the same in all countries. Large countries in particular are less likely to react to peer pressure in the desired way, as the wish to be “good European” typically plays a much weaker role in their domestic politics than in smaller countries.[23] The slippage in fiscal discipline observed in 1999 and 2000 and the fact that France and Germany undertook significant tax measures without referring to them in their Stability programs (European Commission, 2000) support the impression that the effectiveness of peer pressure to secure commitment is limited.

Furthermore, the procedures for cooperative policymaking do not always involve the relevant actors at the national level. This implies that negotiations in the individual processes often can lead to no more than statements of good intentions to persuade the other actors relevant at the national level. Experience suggests that these good intentions do not always lead to good results.

The institutional preconditions are another relevant issue here. Recent empirical studies of fiscal practices in the EU states show a large degree of variation in the implementation of fiscal rules (Hallerberg, Strauch and von Hagen, 2001; Fischer and Reitano, 2001). In some states, the fiscal targets formulated in the context of the Stability Programmes are translated into detailed targets at the level of individual ministries, and the governments have developed a detailed framework enabling them to keep their budgetary aggregates close to the stated targets when revenue or expenditure shocks occur. In other states, the connection between the targets stated in the Stability Programmes and the annual budget process is loose and rules for shocks do not exist. This suggests that the effectiveness of the EDP and SGP as a framework for policy coordination varies across countries. On the other hand, the political economy of fiscal policy shows that the suitability of fiscal targets and multiannual programs to guide a government's fiscal choices and serve as a commitment device depends on political factors such as the organization of government and electoral systems (Hallerberg and von Hagen, 1998). Given the variance of these factors across EU member states, the strong reliance of the EMU on this approach is questionable.

This is also true for the connection between national decision making processes and the processes at the European level. The writing of the Stability and Growth Programs does not typically coincide with the annual budget cycle in the member states. Member states are required to supply their programs before March 1 but agreed to submit these programs before the end of the year. In all countries except the UK, the annual budget cycles start in the fall with the final budget being adopted by the Parliament towards the end of the year or early the following year. How can objectives in the programs and the Council opinions feed back into the national budgetary process and implementation? A late submission, after the adoption by the parliament, may not incorporate the relevance of

[23] It is interesting in this context to note that, during the convergence process to EMU in the 1990s, the small EU countries were much more responsive to the pressures for adjustment of budgetary

the budget on EMU level. This might reflect the strategic choice of that country to avoid a parallel debate at EU and national level but is inefficient with respect to our club good. Given that the aggregated fiscal stance is relevant for the assessment of the macroeconomic policy stance within the euro area, the missing link in the two debate favors the national positions.

IV.3. Quality of Analysis

Policy coordination requires a common framework of analysis showing how macroeconomic developments respond to various types of shocks and to the use of policy instruments at the national and the European level. With regard to the macro economy of the euro area, the sheer fact that EMU is a new entity explains the current lack of such a framework. Researchers at the ECB, the Commission and elsewhere are developing such models. It should be noted, however, that the existing procedures for policy coordination also involve a large amount of analysis of the effectiveness of economic policies at the national level, e.g., active labor market policies in the context of the Luxembourg process. Currently, such analysis is mainly provided by the national governments, and seems to be driven by considerations of political opportunity rather than value of information. There is clearly a need for improvement in this context.

The surveillance of national economic policies and the formulation of credible recommendations require high quality of the relevant statistical information. For example, the effective monitoring of the public finance positions requires information on an on-going basis during the year (Jaquet and Pisani Ferry ,2000). Or, an improved data set on active labor market policies may allow identifying successful labor market strategies across countries within the Luxembourg process. There is still a need for improving the quality and availability of data needed in the existing processes.

The acceptance of peer pressure by member states relies on the methods of analysis used to formulate recommendations. For example, the set of relevant fiscal indicators have to be broadened in order to allow a qualitative assessment of the respective policy stance. A better quality information is also needed to assess the member states performance in conducting structural reforms. Finally, the criteria for the selection of "best practices" particularly in the Luxembourg and Cardiff Processes, which are used as benchmarks for the member states' own practices are far from obvious. These criteria should be spelled out explicitly to assure that the selected cases of "best practice" are adequate for guiding the member states policies.

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policies than the large countries. See von Hagen, Hughes-Hallett and Strauch 2000.

V. Conclusions

EMU has created a new environment for economic policy in Europe. It is characterized by the existence of multiple club goods. In this paper, we have explored the implications of this new setup for economic policymaking in Europe, and reviewed the current processes for policy coordination.

The existing framework is a half-finished house at best. Its greatest vulnerability stems from the lack of an explicit recognition that EMU involves trade-offs both at the aggregate level and between aggregate and national goals of economic policy. These trade-offs require policy choices and create distributional conflicts regarding the cost of adjustment at the national level to ensure a proper functioning of the EMU as a whole.

One might argue that this lack of a more developed framework for policy coordination does not matter much in times of benign economic circumstances and that the member states will find and adopt a solution when times become more difficult in the future. But such an approach bears significant risks: Experience shows that governments want to see quick results in times of crises and that policies adopted under time pressure often turn out to be costly but hard to reverse in the long run. Ultimately, therefore, a wait-and-see attitude is not in the interest of the member states.

It is advisable, therefore, to use the current, favorable circumstances to develop a more complete framework for cooperative policymaking in the EMU. The relevant agenda includes assigning responsibilities and strengthening commitment at the national level, developing a framework for presenting and making the relevant policy choices, improving the quality and the transparency of the processes and the analysis, and developing rules for responding to shocks. Given the reluctance of the national governments to engage in that process, the European Commission should have an interest to take the initiative in this regard. One must recognize, however, that the evaluation of policy trade-offs and distributional conflicts is inherently a political task. The Commission, in its role as a guardian of the proper functioning of the EU and a promoter of further integration should call upon governments to engage in this process and its development. As a non-elected body, however, it is ultimately not in the position to make the necessary decisions itself.

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