

# The economic policy framework in EMU

*The introduction of the euro and the conduct of the single monetary policy by the independent European Central Bank (ECB) have fundamentally changed the framework within which the European Community and its Member States conduct their economic policies. Building on the existing framework of the Single Market, the specific design of Economic and Monetary Union (EMU), as laid down by the Maastricht Treaty, transfers the competence for monetary and exchange rate policies to the Community level, while leaving the responsibilities for fiscal policies, labour market and employment policies and for many microeconomic and structural policies in the hands of the national, or subnational, authorities. This article reviews the allocation of policy responsibilities within the Community's multi-levelled system of economic governance and its performance thus far. In so doing, it places specific emphasis on the existing arrangements for a structured interaction among policy-makers, ranging from more or less constraining forms of policy co-ordination to the free play of competing policy designs. Overall, the economic policy framework in EMU – despite its sui generis nature and appreciable complexity – is viable and capable of producing coherent policy outcomes for the euro area as a whole, provided that all policy-makers fully assume their responsibilities, respect existing rules and the commitments entered into and come to “internalise” the requirements of EMU in their policy actions.*

## I Introduction

The introduction of the euro and the transfer of the competence for the conduct of the single monetary policy and related tasks to the Eurosystem have added an entirely new dimension to policy-making in the European Community. They have also complemented an already comprehensive policy framework that was set up by the Treaty establishing the European Community. The policy-making structures at the European level cover almost all fields of public policy, even though a predominant focus of Community activity is on economic policy in a broad sense, ranging from market regulation to competition, regional development, agriculture or international trade. In this respect, the degree of involvement of Community institutions and bodies in policy-making may vary from exclusive competency (e.g. in the field of agriculture) to supplementary activities (e.g. in the area of social protection). The economic policy framework in EMU – which, for the purposes of this article, is understood as relating to macroeconomic and structural policies – is a core element of the Community's multi-levelled system of governance. Whereas monetary and exchange rate policies, as well as rule-making for the Single Market, are the responsibility of Community authorities, fiscal and employment policies, as well as most

structural policies in the area of national product, labour and capital markets, remain the competence of the Member States or, where applicable, of subnational authorities and other actors.

This article focuses on the allocation of responsibilities for economic policies within the existing framework and reviews the interaction between the different actors at the various levels of governance. It follows up on the description of the ECB's relations with institutions and bodies of the European Community that was presented in the October 2000 issue of the ECB Monthly Bulletin by placing those relations in the wider perspective of the Community's policy-making framework.

The ECB – notwithstanding its independent status – is embedded in the institutional and policy context of the European Community and has to take into account the economic policy framework within which it operates. The functioning of this framework is one of the determinants of general economic conditions, and thus also of the price formation mechanism in the euro area, and therefore has an impact on the outlook for price stability. Moreover, in political and institutional terms, an effective and

transparent framework for economic governance matters for the outside perception of the euro area as an entity in its own right, and thus may help to foster public confidence in the single currency. For these

reasons, the ECB has a genuine interest in a coherent framework for economic policy-making in the euro area and closely follows the debate about its future evolution.

## 2 The Treaty foundations

The Maastricht Treaty established a novel framework for the conduct of economic policy. The constitutional foundations of this framework include a clear allocation of policy responsibilities, a set of shared objectives, guiding principles for the conduct of policies and an institutional set-up with adequate policy instruments.

The Treaty unambiguously assigned responsibility for the single monetary policy and related tasks to the Eurosystem, while the competence for other economic policies, such as fiscal, structural or labour market policies remained with the Member States, even though they are subject to more or less binding rules regarding multilateral surveillance and policy co-ordination. Unlike the first blueprint for EMU, the 1970 Werner Report ("Report to the Council and the Commission on the realisation by stages of economic and monetary union in the Community"), which foresaw a "centre of decision for economic policy" with a "decisive influence over the general economic policy of the Community", the Maastricht Treaty explicitly left economic policies in the hands of the Member States and stipulated that the economic policy of the Community be "based on the close coordination of Member States' economic policies" (Article 4(1), see Box 1). The clear assignment of responsibilities, together with the respect for the independence of the different policy actors, represents a fundamental feature of the relationships among European economic policy-makers. This not only implies that the individual responsibilities of each policy actor have to be respected by the others, it also means that, within its field of competence, each policy actor is clearly responsible for the successful implementation of policies in line with the established rules and objectives.

The Maastricht Treaty also made clear that the establishment of EMU (together with the creation of a Single Market and the pursuit of common policies) is not an end in itself, but rather an instrument to further the fundamental objectives of the Community, which include "a harmonious, balanced and sustainable development of economic activities, a high level of employment [...], sustainable and non-inflationary growth [and] a high degree of competitiveness and convergence of economic performance [...]" (Article 2 of the Treaty, see also Box 1).

Significantly, the Maastricht Treaty also laid down guiding principles for the conduct of economic policies, thereby elevating the goals of "stable prices, sound public finances and monetary conditions and a sustainable balance of payments", as well as the "principle of an open market economy with free competition" (Article 4 of the Treaty, see also Box 1) to constitutional status.

The Treaty chapters entitled "Economic policy" (Title VII, Chapter 1), "Monetary policy" (Title VII, Chapter 2), and "Employment" (Title VIII) flesh out these general principles and provisions and lay down the legal basis for the specific institutional arrangements and the respective policy instruments at Community level. The constitutional foundation of the economic policy framework in EMU, and specifically of the allocation of policy responsibilities, objectives and prerogatives, could – but should not – lead to a static perception of the practical arrangements for policy-making and co-ordination that derive from the Treaty. The latter are continuously being refined in the light of experience. Thus, while the foundations of the economic policy

## Box I

### The Treaty foundations of the economic policy framework

#### Excerpts from the Treaty establishing the European Community

##### Article 2

##### *[Objectives of the Community]*

The Community shall have as its task, by establishing a common market and an economic and monetary union and by implementing common policies or activities referred to in Articles 3 and 4, to promote throughout the Community a harmonious, balanced and sustainable development of economic activities, a high level of employment and of social protection, equality between men and women, sustainable and non-inflationary growth, a high degree of competitiveness and convergence of economic performance, a high level of protection and improvement of the quality of the environment, the raising of the standard of living and quality of life, and economic and social cohesion and solidarity among Member States.

##### Article 4

##### *[General economic policies]*

1. For the purposes set out in Article 2, the activities of the Member States and the Community shall include, as provided in this Treaty and in accordance with the timetable set out therein, the adoption of an economic policy which is based on the close coordination of Member States' economic policies, on the internal market and on the definition of common objectives, and conducted in accordance with the principle of an open market economy with free competition.

##### *[Monetary and exchange rate policies]*

2. Concurrently with the foregoing, and as provided in this Treaty and in accordance with the timetable and the procedures set out therein, these activities shall include the irrevocable fixing of exchange rates leading to the introduction of a single currency, the ECU, and the definition and conduct of a single monetary policy and exchange-rate policy the primary objective of both of which shall be to maintain price stability and, without prejudice to this objective, to support the general economic policies in the Community, in accordance with the principle of an open market economy with free competition.

##### *[Guiding principles]*

3. These activities of the Member States and the Community shall entail compliance with the following guiding principles: stable prices, sound public finances and monetary conditions and a sustainable balance of payments.

framework are anchored in the Treaty, it would be premature to consider the resulting practical arrangements for policy-making as final.

In Section 3 below, a number of basic structural and organisational features of the

economic policy framework are explored. Section 4 then reviews the various arrangements for the conduct of individual economic policies, while Section 5 illustrates how economic policy-making is integrated into a coherent overall structure.

### 3 The policy framework

Even though the set-up for economic policy-making in the European Union (EU) in general, and in the euro area in particular, provides its constituent units, the Member States, with a considerable degree of autonomy in important policy fields, it clearly should not be likened to a loosely-based international co-operation framework (such as the G7). Rather, the economic policy framework applicable to the euro area displays a number of core features that are usually attributed to a domestic system. Comparable to the textbook model of the domestic economy, the euro area economy rests on a Single Market, in which goods, services, capital and labour can circulate freely, with established procedures and institutions for common rule-making and effective enforcement mechanisms. In addition, a single currency has been introduced – which also means a single exchange rate – and a single central bank conducts a single monetary policy. Furthermore, a binding constitution for economic policies has been established by the Treaty which obliges Member States to “regard their economic policies as a matter of common concern” and subjects national economic policies to a dense network of multilateral surveillance and co-ordination.

The novel and *sui generis* nature of the economic policy framework in EMU has sometimes led to premature conclusions about a lack of clarity and even its viability. The complex arrangements for international representation and the absence of an easily recognisable “public face” might also have reinforced this perception. However, allowing the Member States a large degree of autonomy with regard to decision-making in important fields of economic policy, such as taxation, expenditure or social welfare provision, is by no means specific to the euro area. In the United States, for example, the various states are free to set important tax rates and decide on the level of provision of certain public services without being subject to binding common rules or extensive and constraining co-ordination mechanisms. The

complexity inherent in the multi-levelled US system of governance, and even a degree of policy competition among the states, do not undermine the proper functioning and outside perception of the United States as an integrated economy with a coherent framework for policy-making. In the same vein, the decentralised nature of economic policy-making in EMU should not be seen as a “design flaw” – as is sometimes the case. It should be regarded as a strength, for the following reasons.

The balance between centralised and decentralised elements in the economic policy framework of the euro area reflects the application of the principle of subsidiarity. While constitutional in its status and formulation, the subsidiarity principle also reflects the economic rationale that the allocation of policy responsibilities to a higher (i.e. the Community) level is only justified if the Member States cannot achieve the set objectives by themselves, or if the Community for reasons of scale or effects is better placed to achieve them (i.e. if a centralised policy decision produces an added value). Applied to economic policy-making in the euro area, the subsidiarity principle therefore implies that monetary policy, by nature of its singleness and indivisibility, cannot suitably remain decentralised, and hence has been unified in the Eurosystem. The same logic of centralisation also holds for the regulatory framework of the Single Market, since a common market requires a set of common rules together with credible enforcement or at least a joint agreement on the mutual recognition of national norms and standards.

By contrast, fiscal policies, microeconomic and structural policies, as well as labour market and employment policies, have remained national competences, since there are – for the time being – no compelling arguments that could justify a full transfer of these policy responsibilities to the Community level. The flexibility that derives from policy decentralisation provides national

authorities with vital room for manoeuvre. In addition, decentralisation offers scope for the beneficial effects of healthy policy competition. These two fundamental benefits should be considered in turn.

### **Decentralisation offers flexibility and scope for policy competition**

Despite the advanced degree of integration among the euro area Member States, domestic economic structures and preferences have not fully converged, and are unlikely to do so in the near future. These variations in economic structures and preferences call for policy-making structures which provide sufficient flexibility to accommodate such differences and offer a substantial margin of manoeuvre to national policy-makers to adjust to country-specific developments (such as economic shocks) under the conditions of Monetary Union.

The decentralised character of the economic policy framework in EMU also offers scope for healthy policy competition among the Member States. The insight that open competition provides the most appropriate incentives for optimisation and stimulates continuous innovation is applicable not only to firms and industries, but also to the realm of public policies. In the international arena, which often lacks commonly accepted “market rules”, policy competition may accentuate elements of rivalry, with potentially negative effects for all involved. By contrast, the Community represents a fundamentally co-operative and rule-based policy framework in which free competition among differing policy designs is accepted as a normal and efficient element of domestic economic governance within a decentralised system. In this way, an element of competition has been introduced into domestic policy-making, while fully respecting particular national conditions and preferences. Already, national economic policy decisions are subject to critical cross-border comparisons, since policy-makers, businesses, and the public at large are increasingly aware of economic

developments and policy performance in other countries of the Community.

In order to reap the full benefits of constructive policy competition, the Member States have agreed to exchange experiences in order to identify “best practices” and to jointly draw the lessons from flawed or failed policies. The decentralised framework for economic policies in the euro area thus creates a pool of valuable information to the benefit of the Member States and may generate synergy effects which do not exist under a fully centralised policy regime. At the same time, the co-operative nature of the Community also means that policy competition is subject to certain limits in order to avoid a damaging “race to the bottom”, or “harmful competition”, in certain fields of economic policy, such as labour standards, the granting of state subsidies or certain tax measures.

### **Potential spillovers call for policy co-ordination**

However, autonomous decision-making at different levels of government by otherwise interdependent policy-makers can create externalities (i.e. spillover effects). Available estimates of such spillovers point to small, but not negligible, effects. In addition, decentralised and unco-ordinated responses to new market developments (e.g. the emergence of cross-border financial conglomerates) might prove sub-optimal. Entirely autonomous decision-making may also be insufficient to cope with economic shocks that affect all policy-makers alike (such as an oil price surge).

With regard to the specific allocation of policy responsibilities in EMU, two types of spillovers can be identified. First, spillovers can occur *across countries*. In the highly interdependent context of Monetary Union, fiscal laxity in one country might, for example, produce negative effects on other countries, by affecting capital market conditions and generating upward pressure on long-term

interest rates in the euro area as a whole. Second, spillovers can also occur *across policies*. Decisions in, say, the area of tax and benefit systems, may affect the functioning of the labour market and thus have an impact on the effectiveness of measures in another policy field, in this example, employment policy.

Appropriate forms of policy co-ordination, such as agreements on common rules and objectives that serve as an orientation for individual policies, can limit the negative effects of potential externalities. Positive welfare effects can reasonably be expected if there is an opportunity to modify the policy choices of individual policy-makers before their implementation. In such a case, a co-ordination of otherwise autonomous policies, if properly designed, represents a move towards optimal outcomes. Further benefits of co-ordination derive from the provision of valuable first-hand information, which improves the mutual understanding of individual policy decisions and contributes to a climate of trust and reputation, in which “peer pressure” comes into play. By sharing both good and bad experiences, the cost of designing appropriate policies can be reduced and policy errors avoided.

However, a number of preconditions need to be satisfied for policy co-ordination to be desirable and indeed feasible. First, the gains that can reasonably be expected from policy co-ordination have to be weighed against the associated costs. Such costs may arise from the bargaining process itself, which is part of any co-ordination. Second, policy co-ordination also faces operational difficulties. General economic theories of policy co-ordination point to the need for all participants to pursue common policy goals and to agree on a common model, i.e. to share an understanding of how different policy

instruments impact on economic variables and the trade-offs between them. The feasibility of co-ordination also hinges on the ability to aggregate and process the information supplied by the participants and to provide adequate incentives to ensure individual policy-makers’ continued commitment to the regime.

In spite of these caveats, close co-ordination among the Member States has been enshrined in the Treaty as a fundamental principle of the economic policy framework (see Box I). The actual design of the various co-ordination processes has had to be sufficiently flexible to reap the full benefits of co-ordination while also addressing the aforementioned costs and operational drawbacks. Among the various modes of policy co-ordination, the most constraining form involves agreements on “joint rules” for the conduct of otherwise autonomous policies so as to reduce, or eliminate, the potential negative effects of policy spillovers. The binding quality of the common rules derives from the existence of credible enforcement mechanisms. Less binding forms of co-ordination include the establishment of “joint fora” that allow close and regular interaction between policy-makers, so as to raise their awareness of the interdependence of their decisions. Such interaction takes the form of policy dialogue, exchange of information or shared analysis. Despite its non-binding character, this form of “soft” co-ordination does not prevent policy-makers from agreeing, occasionally, on joint courses of action. However, by relying exclusively on “peer pressure”, persuasion and the issuing of policy recommendations, soft co-ordination lacks the disciplining instruments that might be needed to guarantee that the policy measures considered necessary or desirable are actually implemented.



## 4 The conduct of individual economic policies

Complementing the thus far systemic approach, this section outlines in more detail how the different economic policies are conducted within the overall economic policy framework. Each policy field is addressed individually (i.e. monetary policy; exchange rate policy; fiscal policy; labour market and employment policies; microeconomic and structural policies), and specific emphasis is placed on the allocation of the respective policy responsibilities and the reasoning behind it, on the actual formulation of policies and, where applicable, on the co-ordination *across countries* for the specific policy fields. Section 5 will illustrate how these specific arrangements for individual policies are integrated into a coherent overall framework for economic policy co-ordination among the Member States and discuss existing practices for co-ordination *across policies*.

### Monetary policy

The importance of price stability for the efficient functioning of the market mechanism implies that, within a single market, a stability-oriented monetary policy is a common public good which should be provided in a uniform manner by an independent and central institution. The institutional framework for monetary policy in EMU clearly reflects this need. The Treaty has established the Eurosystem with the ECB at its core, which has been endowed with the necessary independence from political interference and has been given a clear mandate to maintain price stability within the euro area. In this way, the institutional framework serves to ensure that monetary policy contributes in the best way it can to the achievement of the overall objectives of the economic policies of the Community.

In order to support the smooth operation of the single monetary policy and to further underscore the ECB's independence, the Treaty also prohibits monetary financing of public deficits by the central bank (Article 101)

and privileged access for public authorities to financial institutions (Article 102).

### Exchange rate policy

A single currency necessarily means a single exchange rate. Hence, exchange rate policy is also conducted at the Community level. It should be noted that there is no "active" exchange rate policy in the euro area. Given the size of the euro area economy, the ECB does not have an exchange rate target. The Treaty lays down that any exchange rate policy should be consistent with the primary objective of the ECB's monetary policy, which is to maintain price stability. With regard to the implementation of exchange rate policy, the Treaty foresees a close interaction between the EU Council and the ECB. In cases where this were to be deemed necessary, Article 111 of the Treaty allows the EU Council, following specific and stringent procedures, to conclude formal agreements on an exchange rate system for the euro in relation to non-Community currencies or to formulate general orientations for exchange rate policy. However, any agreement or general orientations must be consistent with the objective of the ECB to maintain price stability.

The provisions of the Treaty and the Statute of the European System of Central Banks and of the European Central Bank, as well as current institutional arrangements, ensure that regular exchanges of information and views take place between the EU Council and the ECB. This is consistent with the fact that exchange rate developments are a matter of common interest for both authorities. However, the ECB is solely competent for deciding whether and when to use the instrument of foreign exchange intervention, in keeping with its independence, the tasks entrusted to it by the Treaty and Statute and its primary objective of maintaining price stability. Thus, the institutional and practical

arrangements of the euro area in the field of exchange rate policy – in spite of their peculiarities (such as the autonomous role of the central bank and the absence of a “euro area finance ministry”) – establish a capacity for coherent policy-making which facilitates communication and permits, if deemed appropriate, effective co-operation with the euro area’s main international partners.

### **Fiscal policy**

Fiscal policy is conducted at the level of the Member States in accordance with the rules of the Treaty and the Stability and Growth Pact (SGP), which leave substantial room for manoeuvre regarding the composition of public spending and revenues in line with national political preferences. The individual responsibility of the Member States in the field of budgetary policy is explicitly underscored by the Treaty’s “no bail-out” clause (Article 103), which stipulates that neither the Community nor any Member State shall be liable for the commitments of another Member State. There are a number of arguments in support of this decentralised approach to fiscal policy.

First, national policy preferences, with regard to both revenue and spending, still predominate within the euro area. The size of budgets as well as tax and spending priorities vary, in some cases considerably, among Member States. This is a reflection of the fact that important “public goods” such as social security, education, health care or defence are provided at the national level. Since the underlying political debates about these major components of public spending still maintain a country-specific focus, the respective policy decisions have to remain – not least for reasons of political legitimacy – at the national level.

Second, despite considerable progress on the path to cyclical convergence among euro area Member States, certain differences with regard to cyclical positions remain. Since the Eurosystem conducts its monetary policy for

the euro area as a whole and hence cannot respond to the specific needs of individual economies, Member States have to take the euro area monetary policy stance as exogenously given. Consequently, national governments must be able to respond to the particular cyclical position of their domestic economies in a differentiated and flexible manner, with the policy instruments at their disposal – notably fiscal policy. By keeping national budgets close to balance or in surplus over the medium term, national governments should be in a position to smoothen the economic effects of cyclical fluctuations through the operation of automatic stabilisers and, if need be, further action within the limits of the SGP. In addition, structural reforms may increase the capacity of economies to adapt to economic shocks in a self-stabilising manner.

As referred to in Section 3, decentralised fiscal policies within EMU must take into account the potential for spillover effects which policy decisions in one Member State can have on the others. Already before EMU, the need to avoid distortions of the Single Market had entailed a limitation of the Member States’ room for discretion with regard to certain kinds of taxation (e.g. minimum rates of value added tax). Beyond that, the present framework for the conduct of fiscal policies has been designed to minimise the risk of negative spillovers from inappropriate fiscal policies. It establishes, on the basis of Treaty provisions and secondary legislation, a regime which is best described as “constrained flexibility”. First and foremost, “sound public finances” are a guiding principle of economic policy-making in the Community (Article 4 (3), see Box 1). Moreover, the aforementioned prohibition of monetary financing of public deficits by the central bank and of privileged access for public authorities to financial institutions represents further fundamental and binding restrictions on the conduct of national fiscal policies. By enhancing the disciplining effects of the market mechanism on fiscal policies, they contribute to the proper functioning of EMU.



Most importantly, the Treaty contains an obligation to avoid “excessive deficits” (Article 104). This constraint, together with procedures for a multilateral review of national fiscal policies, has been further specified by the SGP. The SGP stipulates quantifiable debt and deficit rules which provide a clear policy orientation for the budgetary authorities in the Member States (see also the article entitled “The implementation of the Stability and Growth Pact” in the May 1999 issue of the Monthly Bulletin). In accordance with the SGP, euro area Member States are required to submit annual stability programmes outlining their budgetary plans in conformity with the medium-term objective of budgetary positions close to balance or in surplus. The considerable progress that has been made in reducing budget deficit and debt levels since the mid-1990s is evidence that the overall framework for fiscal policies has worked well.

This does not mean that practical improvements will not be possible as experience is gained. In fact, useful improvements to the existing framework have already been made. For instance, the finance ministers of the euro area have agreed to share prior information and, where necessary, discuss any projected major changes to future tax and spending plans within the Eurogroup (for a detailed presentation of the role and functioning of the Eurogroup, see the ECB Annual Report 2000). Moreover, a joint exercise to assess the “quality” of public finances, i.e. the structural features of national budgets, has recently been started. This allows a reciprocal learning process which helps to address longer-term challenges for fiscal policies, such as the budgetary impact of ageing populations. These forms of fiscal policy co-ordination which go beyond the SGP are of an informal and non-binding nature. Their credibility and effectiveness will therefore depend on policy-makers’ resolve to honour the commitments entered into.

Over time, co-ordination practices might evolve further. An agreed overall stance of fiscal policy may gradually emerge, influencing

the conduct of national budgetary policies, on the basis of voluntary agreements among euro area finance ministers. As part of such an evolution, domestic fiscal policy could come to be defined also with reference to the aggregate effects for the euro area, and thus foster the internalisation of the specific conditions of Monetary Union on the part of the national policy-makers.

### **Labour market and employment policies**

Labour market and employment policies refer to the actions of governments, employers and trade unions in setting the framework for functioning labour markets and in negotiating wage settlements. In order to contribute to achieving the economic objectives of the Community, wage developments should be conducive to a high level of employment and consistent with price stability. To this end, wage levels should, as far as possible, reflect and adjust to the demand for and supply of labour across different industries, sectors and regions as determined by overall demand and supply conditions, as well as differences in labour productivity.

Wage negotiations are conducted at national, subnational, industry or firm level, and they are generally in the hands of the social partners. Responsibility for the general framework parameters for the national labour markets lies with the governments of the Member States. This degree of decentralisation of labour market and employment policies is widely seen as warranted since there exist substantial differences within the euro area in industrial and labour market structures and productivity levels across different industries, sectors and regions. In fact, greater labour market flexibility and, where appropriate, reform of wage formation systems so that these better reflect local productivity and labour market conditions would be important steps to tackle the high rates of structural unemployment which still persist in a number of Member States. While progress has certainly been made in these areas, the introduction of the

single currency has given greater urgency to the task of removing rigidities and perverse incentives in labour markets, not least since labour mobility remains very limited, not only between, but also within individual countries.

However, since all Member States are committed to the common goal of a “high level of employment” (Article 2 of the Treaty, see Box 1) and share concern over the current high levels of unemployment, a consultation and co-ordination process among the Member States has been established at the Community level. Title VIII of the Treaty, which is entitled “Employment” and was introduced with the Amsterdam Treaty of 1997, makes the hitherto purely national employment policies subject to a formal co-ordination procedure, commonly referred to as the “Luxembourg process”. The main policy instrument for this is the annual Employment Guidelines, whose endorsement by the Heads of State or Government underscores their political relevance. These guidelines set out recommendations and priority areas of action, especially with regard to training and education and labour market reform. National Employment Action Plans transpose these orientations into policy proposals operational at national level, taking into account the specific conditions in the Member States. As pointed out above, the full benefits of Community-level co-ordination and consultation processes can only be reaped if the guidelines and recommendations are actually followed up at the national level and the detailed policy measures contained in the National Action Plans are duly implemented.

### **Microeconomic and structural policies**

Microeconomic and structural policies are understood as encompassing public policy measures that affect the functioning of markets and the allocation of resources within them. The respective policy responsibilities are divided between the Community and the national level. As referred to above, a fundamental pillar of the economic policy

framework in EMU is a functioning Single Market. In the pursuit of the Treaty objective of establishing a Single Market “characterised by the abolition, as between Member States, of obstacles to the free movement of goods, persons, services and capital” (Article 3.1(c)), the Community has enacted a substantial body of legislation governing the functioning of markets. This comprehensive set of rules in the form of Community legal acts, in particular regulations and directives, which derive their binding force from the existence of functioning enforcement mechanisms (competition policy, rulings of Community courts), covers many aspects of economic life and affects a wide range of the decisions taken by economic agents and policy-makers. Progress towards the common goal of establishing a level playing-field across the entire Single Market has, over the years, already led to significant structural changes in European economies: as competitive pressures have increased and previously protected and monopolistic sectors of the economy have been opened up to competition, the Community’s growth, competitiveness and employment performance has improved.

However, within the framework of the Single Market, national governments retain the responsibility for a number of important structural policies (e.g. regulations concerning labour markets, network industries, research and development, etc.). This decentralisation is not only justified on the grounds of differing economic structures and political priorities in the Member States. In accordance with the principle of subsidiarity, policy action with regard to microeconomic and structural issues, for instance on modalities for worker co-determination in the workplace or social welfare and benefit systems, should normally be taken at the national – or even subnational – level. Common rules at Community level can only be justified if they provide added value due to scale effects or become necessary to support the proper functioning of the Single Market. In this respect, differing framework conditions and regulatory environments, e.g. in the field of financial markets or access to network

industries, might call for common approaches if they hamper the operation of the Single Market.

Measures to enhance competition in product and services markets and further steps to open up those sectors of the economy that were previously sheltered from competition will benefit, first and foremost, the country that adopts them. Increasing competition is likely to lead to cost reductions, lower profit margins and productivity gains, which, in turn, can be expected to produce a temporary downward effect on consumer price inflation. Lower prices and better quality will, over time, lead to increased demand for goods and services. Moreover, structural reform can improve the competitiveness as well as the flexibility of the national economy to respond to shocks, which is particularly important for a country that is part of a monetary union where country-specific interest and exchange rates are – by definition – not available as instruments for economic adjustment (see also the article entitled “Product market reforms in the euro area” in the August 2001 issue of the ECB Monthly Bulletin).

Beyond these domestic benefits of structural reform, euro area countries also have a mutual interest in the progress of structural reforms in other Member States sharing the common currency. This interest derives from the aforementioned beneficial impact of structural reforms on a number of key variables of the euro area as a whole. Progress of structural reforms throughout the euro area, with the resulting improvements in competitiveness and flexibility, can increase the euro area’s growth potential and employment prospects. This, in turn, may significantly enhance the outside perception of the euro area as a vibrant and dynamic economy. Moreover, a reduction of structural rigidities in euro area economies can support the conduct of the single monetary policy, since greater flexibility helps to lower price pressures at a given level of growth, which, in turn, may lead to an increase in the potential level of output and employment growth that is compatible with price stability.

In recognition of the euro area-wide relevance of structural reforms, the Member States have agreed to institutionalise a system of reinforced monitoring and “peer review” in what is known as the “Cardiff process”. In the framework of this procedure, Member States and the European Commission report, on an annual basis, on the functioning of product and capital markets and on the progress of economic reform. This exercise derives additional force from a more in-depth “multilateral review of economic reforms” conducted by the Economic Policy Committee of the European Community. By way of a country-specific examination of intended and implemented structural reforms, the exercise creates significant “peer pressure”. The fact that the Eurogroup now also devotes part of its discussions to structural reforms bears witness to the perceived benefits of this reciprocal learning process. Regular interaction among policy-makers, joint appraisals of past experiences and frank discussions about the merits and drawbacks of competing policy designs may also further the “philosophical convergence” on the necessary policy responses. Once a basic consensus has emerged with regard to a common approach, common policy measures can be adopted, if deemed desirable. To that end, the Community legislative process might be used, which allows the making of rules that are binding and applicable throughout the Community.

An additional political impetus from the Community level for further progress of structural reform came from the 2000 Lisbon European Council. The “Lisbon Strategy” established a comprehensive reform agenda which aims, *inter alia*, to enhance the functioning of the Single Market and overcome existing fragmentation and inefficiencies in areas as varied as securities markets, access to risk capital or air traffic control (for a more detailed description of the Lisbon Strategy, see the ECB Annual Report 2000). As shown by the first review of progress at the Stockholm European Council in 2001, adherence to the jointly established timetables and an effective

implementation of the agreed measures are likely to be the real test of the Member States' commitment to reach the strategic

goal set at Lisbon, namely to transform the EU into "the most competitive and dynamic knowledge-based economy in the world".

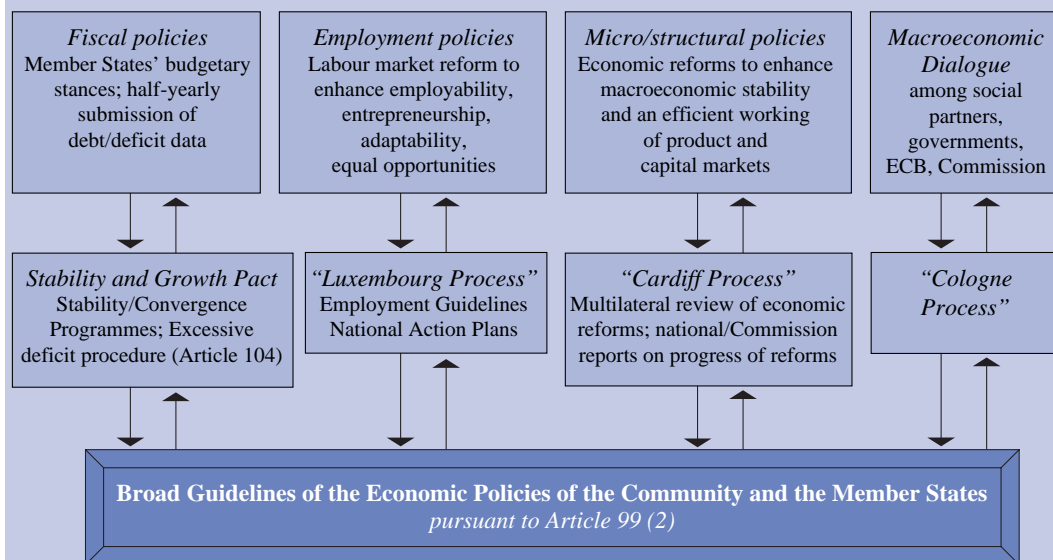
## 5 Co-ordination across countries and interaction across policies

As the previous section illustrated, the decentralised nature of policy-making in the fields of fiscal, employment and structural policies rests on sound economic reasoning and reflects the rationale of the subsidiarity principle. This notwithstanding, and in full recognition of the benefits and difficulties of policy co-ordination, the Member States have developed a dense network of multilateral procedures and the joint use of a number of important policy instruments. In order to give coherence to the overall economic policy framework, the Treaty establishes the annual Broad Economic Policy Guidelines (BEPG) as the principal and overarching policy instrument for the co-ordination of economic policies at Community level. These guidelines, which – with due respect for the independence and statutory mandate of the ECB – do not apply to monetary policy, render operational the fundamental principle of close co-ordination (Article 4(1), see Box 1). They contain orientations for the general conduct of economic policy and make specific recommendations to each Member State and to the Community. By outlining the necessary measures in different policy fields, e.g. public finances, structural reform, taxation, labour market regulation, or training and education, the BEPG set the standard against which subsequent policy decisions – both at national and Community level – have to be measured and justified. The BEPG represent an instrument of "soft" co-ordination – in that they are not backed up by strong enforcement mechanisms – and instead rely on persuasion, such as the issuing of recommendations and opinions, and "peer pressure" to galvanise governments into appropriate policy action. However, their endorsement by the Heads of State or Government endows them with substantial political weight.

By virtue of their overarching character, the BEPG also help to foster consistency across

policies in the euro area. As outlined in Section 3, autonomous decisions by interdependent policy-makers can create spillovers across policies, regardless of the number of levels of governance. In the textbook model of the domestic economy, however, any externalities that might arise in this context can be fully internalised, since the decisions of the finance minister (e.g. on tax and benefit systems) and the labour minister (e.g. on employment measures) are usually fully integrated in a coherent policy programme of the national government. In the same vein, the BEPG aim to avoid contradictions between the different policy areas by drawing on input from the various compositions of the EU Council (for example Economic and Financial Affairs, Labour and Social Affairs, Internal Market) and other specialised European bodies.

The BEPG are thus the pivot of the more specialised co-ordination and consultation processes (for fiscal policy, employment policy, structural reforms), uniting them under a single overarching structure and gearing them towards a single timetable (see Box 2). While the basic orientations of the BEPG provide the principal policy messages which also feed into the more specialised co-ordination processes, the latter allow a more thorough treatment and analysis of specific topics and an effective monitoring of Member States' implementation of the respective policy recommendations. The lessons learnt from the specialised processes, in turn, feed as input into a new set of BEPG for the following year. In addition, the Commission presents an annual report on the implementation of the recommendations made in the BEPG, so as to add an effective "stock-taking" assessment to what would otherwise be purely forward-looking policy orientations.

**Box 2****Co-ordination of economic policies among the Member States – Broad Economic Policy Guidelines (Article 99)**

Source: European Commission, DG-ECFIN.

Building on the Treaty-based economic policy instruments, and with a view to enhancing their efficiency, the Member States adopted, at the Lisbon European Council of March 2000, a new "open method of co-ordination" in order to support the propagation of best practices in economic policy and to make further progress towards achieving the main objectives of the Community. Manifesting a new commitment to press ahead with further economic reform, the open method of co-ordination includes (i) agreements on policy guidelines together with specific timetables for their implementation; (ii) the establishment, where appropriate, of global indicators and benchmarks to measure progress; (iii) the setting of targets for the translation of these guidelines into national and regional policies; and (iv) the periodic monitoring and evaluation of results. In applying the open method of co-ordination to policy issues as varied as pension systems or social inclusion measures, variable forms of partnership are to be developed, involving not only Community institutions and national governments, but also regional and local authorities, social partners and representatives of civil society.

The Member States have thus put in place a method of economic governance which combines the benefits of partial centralisation – i.e. agreements on common guidelines, timetables, benchmarks and indicators – with the degree of decentralisation which is required by the differing economic structures and preferences of the Member States. Moreover, the decision to dedicate the annual spring meeting of the European Council to economic reform has added the necessary political impetus for an effective review of the progress made and for possible additions to the common reform agenda.

**The role of monetary policy in the overall economic policy framework**

As already noted, the single monetary policy represents a fundamental pillar of the system of economic governance in the euro area. Since the ECB is part of the overall economic policy framework, appropriate channels for a structured exchange of information and views with other policy-makers have been established. This is in line with the established practice in modern domestic frameworks

where an independent central bank and the finance ministry maintain informal contacts to exchange information about economic developments and prospects, and offer insight into each other's analysis and perception of the policy challenges ahead. These connections are in no way misunderstood as an *ex ante* co-ordination of monetary and fiscal policy stances. In the same vein, the regular and structured dialogue between the ECB and national governments clearly excludes any *ex ante* policy co-ordination or joint agreements aimed at achieving a pre-determined policy-mix. In full respect of the

independence of the ECB, these contacts take the form of a non-binding policy dialogue, organised within the Community institutions and bodies (see article entitled "The ECB's relations with institutions and bodies of the European Community" in the October 2000 issue of the Monthly Bulletin). The ECB's involvement in the Eurogroup, the Economic and Financial Committee or the Macroeconomic Dialogue, for example, allows an open dialogue, exchanges of views and shared analysis, in full respect of the responsibilities and prerogatives of all the participants.

## 6 Conclusion

The Maastricht Treaty has established a comprehensive constitution for economic policies in the European Community, which, together with a functioning Single Market and the successful introduction of a common currency, endow the Community with a complete economic policy framework. In order to account for the diversity of economic structures and preferences among euro area Member States, the framework exhibits a considerable degree of decentralisation for important fields of economic policy-making. However, it provides for consistent policy-making for the euro area as a whole, since it rests on a clear allocation of policy responsibilities, the definition of the policy objectives and guiding principles – notably stable prices, sound public finances and open competition – and a network of interaction among policy-makers, ranging from more or less constraining forms of policy co-ordination to the free play of competing policy designs. In spite of its specific features, it shares a number of important elements with the textbook model of a domestic economy and is not so dissimilar to existing frameworks of federal entities such as the United States.

Experiences from the first three years of EMU suggest that the existing framework is properly adapted to the specific conditions of the current stage of development of the

Community. Based on the soundness of its underlying economic reasoning, the framework has thus proven to be a viable arrangement. The multiple channels of communication between policy-makers also foster an increasing awareness of the interdependencies created by Monetary Union, and, in this way, contribute to the internalisation of the requirements of EMU by policy-makers. The recent "philosophical convergence" on the need for structural reform and the new political momentum behind a swift implementation of the Lisbon reform agenda also shows that the current framework is capable of addressing important policy challenges.

Notwithstanding the above, certain operational adaptations of the existing framework – in full respect of its constitutional foundations – may be called for in the future, once the implications of EMU have fully materialised and further experience has been gained with regard to the use of multilateral procedures and common policy instruments. Existing practices and procedures will need to remain under constant scrutiny and a continued reflection on improving the architecture and efficiency of the framework is therefore warranted. However, the overall viability and credibility of the euro area's economic policy framework rests, above all, on the effectiveness of the



existing processes for co-ordination among governments. By focusing their political energies on their own responsibilities and on honouring the commitments made within current mechanisms, the Member States can make an important contribution to the success of EMU and to an improvement of

the outside perception of the euro area's system of economic governance. In the medium and longer term, however, the future constitutional development of the European Union as a whole will also influence the further evolution of the economic policy framework of EMU.