The Institutional System of Fiscal Policy Coordination

2.1 Theory of institutional fiscal policy coordination

Rationales for fiscal policy coordination in EMU

Rationales for fiscal policy coordination in EMU are one of the most challenging topics on the current European economic agenda. This current relevance stems from the fact that although it was Germany that required the strict and formal system of fiscal policy coordination for EMU, this chapter will finally show that, surprisingly, it has been Germany that has had the most difficulties in complying with the common rules for national fiscal policies in EMU. The making of a common European fiscal policy through the institutional system of fiscal policy coordination has thus pointed to significant limitations. This chapter will analyse the political, economic, institutional and legal foundations of European fiscal policy coordination and examine the extent to which this foundation in practice constrains national fiscal policy in EMU.

The starting point for analysing the theoretical and practical aspects of fiscal policy coordination is the fact that monetary instruments, exchange rate, and interest and credit rate policies are no longer available to boost exports and accelerate growth in EMU Member States since the establishment of the ECB in 1999. As the primary objective of fiscal policy coordination is to secure fiscal discipline for monetary stability in EMU, the Stability and Growth Pact requires Member States to keep national budgetary policies within the three percent deficit and the 60 percent debt criteria. The key argument of the traditional Keynesian macroeconomic model and the optimum currency area theory for fiscal policy coordination is that by stabilising the fiscal elements of national economic policies in a monetary union it is possible to contribute to long-term economic stability and growth. For other economists, however, such as Artis and Winkler, the fundamental problem of economic policy coordination relates to “national and aggregate European fiscal policies and the common monetary policy, rather than across national fiscal authorities alone”.1 In practical terms,
monetary and fiscal policies of participating economies have to be consistent in EMU because major debt and deficit stocks could undermine the ECB’s main objective: price stability. The purpose of monetary and fiscal policy coordination in EMU is thus to eliminate economic problems and prevent them from escalating through coordinated policy actions to deal with any economic shocks, whether symmetric or asymmetric.2

Regarding effective national economic policy-making, economists have debated whether increasing fiscal policy coordination has only advantages or whether it also causes some disadvantages in EMU. The main disadvantage of EMU for participating Member States has been the shift of ultimate monetary authority from national control to European authority: the fact that monetary policy instruments are no longer at national governments’ disposal has meant completely new requirements for national fiscal policy instruments, adjustments and flexibility. The political and economic impact of this disadvantage depends primarily on what alternative mechanisms and instruments there are available to secure effective adjustments to symmetric and asymmetric shocks in Member States in EMU. Fiscal policy instruments have a major role in the event of an asymmetric demand-side, country-specific shock, whereas symmetric shocks are most effectively eliminated collectively in the Euro area by the monetary supply-side instruments of the ECB. If an economic shock, whether demand-side or supply-side, has a substantial impact on the whole Euro area, close policy coordination also occurs as an effective policy measure. In perfectly flexible markets, national adjustments would not be required because production factors would stabilise the impact of asymmetric shocks automatically and instantaneously. However, the current EMU area is not considered perfectly flexible by the optimal currency area theory and thus, the function and movement of production factors, such as labour and capital factors, cannot stabilise national economies across and within countries automatically and instantaneously.3

Some economists, such as Breuss and Weber, define an ideal Euro area to be an economic area in which “the single monetary policy would, given the primary objective of preserving price stability, be able to provide a common response to aggregate economic development, whereas decentralised budgetary policies and other national economic policy instruments would be available for responding to country-specific circumstances”.4 In current European economic circumstances, it is the fiscal policy that has the primary responsibility for providing required flexibility for national economic policy-making in EMU Member States. Ideally, “in the case of a full cooperation, where the 12 EMU countries coordinate their fiscal policy with the monetary policy of the ECB the welfare gains obtained are very large for Euroland as a whole”.5 However, there is no “full cooperation” between fiscal and monetary policies in EMU at the moment, and the development of effective economic, fiscal and monetary, and policy co-