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Coordination of Monetary and Fiscal Policy in the European Monetary Union

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Given the presence of numerous fiscal policy holders and only one central bank within the European Monetary Union, the coordination of macroeconomic policies has two dimensions – the coordination among fiscal policy holders and the coordination among monetary and fiscal policy holders. Under the influence of the Global Economic Crisis, the need arose to enhance the coordination mechanism and to have a new instrument for the monitoring and coordination of fiscal and economic policies in the European Union. Using an analytical and deductive methodology, this paper aims to present a brief overview of the existing theoretical research of the said issue, showing at the same time the changes in the EMU coordination mechanism created in consequence of the crisis and emphasizing the challenges that this new mechanism already faces.

Keywords: coordination, monetary policy, fiscal policy, European Semester, European Monetary Union, spillover effect, Global Economic Crisis.

1. Introduction

The weaknesses in the pre-crisis mechanism of coordination of economic and fiscal policies have been particularly evident in the two pillars for constraining national fiscal policies in the EU – the Maastricht Treaty and the Stability and Growth Pact (SGP).

These were the reasons which brought forth a systemic reaction by the EU, with the reform of the SGP through the adoption of The Six Pack, The Two Pack and the Fiscal Compact contained within the Treaty on Stability, Coordination and Governance (TSCG), and with the creation of the Euro Plus Pact. In addition, the need was recognized to create a new instrument of monitoring and coordination of economic and fiscal policies, in the form of the European Semester.

2. Overview of the theoretical studies on the monetary and fiscal policy coordination in the EMU

Theoretical studies on monetary and fiscal policy coordination, especially within the EMU, are of a relatively recent date. For a long time, the instruments of the monetary and the fiscal policy were regarded as alternative one to the other, in the process of achieving the end goals of the economic policy. Therefore, the studies focused more on assessing which instruments were more efficient in achieving a concrete objective, and less on their coordination. General conclusions were drawn from the IS-LM model and the Mundell-Fleming model describing an open economy. Abandoning the Keynesian-monetarist controversy, which is based on the affirmation of one instrument of the economic policy at the expense of the other, the space was cleared for a more detailed analysis of their combined application. The other reason for excluding the analyses of the monetary and fiscal policy coordination in the function of their optimal combination was related to the fact that in most cases both instruments were controlled by one policy maker, i.e. one state.

For this reason, the focus was later shifted towards the need for coordination of instruments and measures of monetary and fiscal policy in the function of achieving the end goals of the economic policy. However, the special coordination established between the policies in highly integrated areas, such as the EU, has become another topic of interest in macroeconomics at the present time. The legal basis is laid in the Maastricht Treaty, which emphasizes the need for coordination at the appropriate levels.

Such coordination differs from other examples of coordination because of the particularities related to the decision-making processes in the field of economic policy. The distinctiveness is reflected in the unique monetary policy implemented through the ECB, and the separate fiscal policies which have been so far under the direct and exclusive authority of the Member States. The very division of jurisdiction between the national and supranational authority within the EMU, i.e. the existence of many individual fiscal authorities and only one monetary authority, lends more importance to the establishment of adequate monetary and fiscal policy coordination in the Euro zone, when compared to other models. This is also one of the reasons for which there is a plethora of theoretical and empirical studies on the issue in the literature.

Considering that within the EMU there are many fiscal policy authorities and only one monetary policy authority, the coordination of macroeconomic policies may have two dimensions, namely, it can be manifested in the coordination among the fiscal policy authorities, and in the coordination among the monetary and fiscal policy authorities. Therefore, Buti (2003) remarks that the relevan
t literature which considers the coordination issues in fact deals with the question whether the possible coordination among fiscal authorities in the Union would have a positive effect on the Member States if the Central bank is not part of the coordination, and whether the full-blown coordination of the fiscal and monetary policy authorities is desirable in the first place.

In this context, it is possible to group the studies of coordination (interaction) among fiscal policies, and among monetary and fiscal policies in the monetary union, separating those which analyze the pros and cons of the establishment of coordination with respect to its compliance with the following criteria:

- Possibility of obligations of policy makers;
- Using the coordination in all countries, or only in some;
- Ability to agree on the goals;
- Monetary regime used.

Coordination is necessary and useful if the policy makers are able to commit within the models they use, while in the reverse case, due to reduced benefits, the coordination within a monetary union is not recommended (Rogof, 1985; Kehoe, 1989; Canzoneri and Henderson, 1991; Jensen, 1996).

The second group of studies concerning coordination within the monetary union analyzes the presence or absence of benefits depending on whether the coordination principle is applied to all members of the Union, or only to some of them. In the context of the centralized monetary policy and decentralized fiscal ones, if the coordination principle is applied to all of the members, the resulting benefits are significant. If not, the coordination among the monetary and fiscal authorities can lead to a reduction of welfare (Beetsma and Bovenberg, 1998; Beetsma et al., 2001; Eichengreen and Ghironi, 2002).

If, however, there is full agreement between the monetary union members on the goals of the economic policy, they will be able to achieve optimal revenue without coordination among fiscal authorities (Dixit and Lambertini, 2001, 2003(a)). When the monetary policies are mutually uncooperative, the coordination of fiscal authorities is unnecessary.

Another way of systematizing the above-mentioned studies is to separate those which have dealt with the so-called Free Rider Problem. Namely, having in mind that the EMU weakens the incentives directed towards national states to consider the consequences of their policies in the context of the financial stability, price stability and external balance, because the benefits of the 'more considerate' policies will partly fall on other Union members, a significant number of theoretical studies on coordination focus precisely on this issue (Dixit and Lambertini 1999, 2001; Beetsma and Bovenberg, 2001; Uglig, 2002). In this context, coordination – especially among fiscal authorities – is necessary in the Euro zone, especially if it is confronted by symmetrical shocks, more so if the shocks concern the supply (Buti, Roeger and int'Velt, 2001). In addition, Anderson (2002) has proven that the inefficiency in case of lack of coordination is increased if the nature of the shock is such that it concerns all countries, while in case of individual shocks it is decreased.

Moreover, the basis for grouping the similar studies dealing with role-modelling in the monetary union, its stochastic character and its interaction with the fiscal policy within the union, can be constituted by the issue whether the model refers to a closed economy or not.[1]

Due to the increasing importance of economic spillovers and externalities inside the EMU, dynamic models of the game theory have been developed in relation to the interaction of the monetary and fiscal policies (Engwerda, 1998; Engwerda et al., 1999; Engwerda et al., 2002). Dixit (2001) has developed a number of models for the EMU and the ECB in the function of the various standpoints of some countries on the monetary and fiscal policy. Kirsanova et al. (2005) develop the model based on three equations related to the Taylor rule in order to consider the stabilization aims of the monetary policy, with the tendency to develop the model on five equations so as to take into account fiscal policy as well. Favero (2004) further analyzes the complementarity, i.e. the substitution of the monetary and fiscal policies with respect to the type of shock that affects the economy, as well as the benefits of the countercyclical fiscal policy if the monetary and the fiscal rules are mutually coordinated. Ferrero (2006) also gives an adequate contribution, analyzing the optimal monetary and fiscal policy in the framework of the monetary union in a way which also includes distortive taxes and government debt.

However, the relationship between monetary and fiscal policies in the framework of the monetary union has most often been analyzed through the new dynamic Keynesian model of general equilibrium, the DSGE model, which can also be a variable for grouping the related studies. Using this type of model, Forni et al. (2010), Rabanal and Aspachs–Bracons (2011), Stahler and Thomas (2011) and Erceg and Linde (2012), all pay special attention to the different approaches to fiscal policy within the monetary union.

3. Spillovers between monetary and fiscal policies in the EMU

The interconnectedness of the monetary and fiscal policies is such that it is often difficult to draw a neat borderline between them. For this reason, it is often emphasized that the interconnectedness is evident and that it is implemented through various direct and indirect channels. The policy spillovers in the EMU are also heterogeneous and achieved in different directions and through diverse channels – fiscal policy affects the monetary policy, and vice versa, especially considering the range of effects that monetary policy can have on the fiscal one (Lane, 2003, p. 157-163).

A standard channel though which monetary policy achieves influence over the fiscal policy is connected to interest rates, due to the fact that the expenses of servicing the government debt in an economy, as well as its own servicing, depend on the level of interest rates. Another channel through which monetary policy can influence the fiscal one concerns the volatility and the level of inflation rate. Besides the tendency to increase government spending, which almost as a rule follows the inflation tendencies, the volatility of the inflation rate makes the fiscal position of the country significantly unpredictable. The third channel concerns the application of monetary strategy, which also represents an indirect way for achieving influence over the fiscal policy. This occurs as a rule when there is a lack of harmonization between the objectives of the monetary and the fiscal policies, so the application of different monetary strategies aimed towards achieving the monetary objective in this case may also determine the objective of the fiscal policy, thus also representing one of the ways in which monetary policy influences the fiscal one.

The relevant literature[2] also shows that fiscal policy achieves influence over the monetary policy in many different ways. One of the channels thanks to which this influence is achieved is the intertemporal budget constraint which affects the monetary policy, determining the price level. Sargent and Wallace (1981) have proven that in the so-called fiscally dominant regime, in which the fiscal authorities independently determine the budget, define the level of budget deficit and the necessary level of government revenue which has to be collected through the emission of bonds or revenues resulting from seigniorage, the monetary authorities do

[1] A special contribution was given by Woodford (2003), and in the studies concerning the open economy– Obstfeld and Rogof (2002), Devereaux and Engel (2000), Corsetti and Pesenti (2001), Beetsma and Jensen (2002).
[2] For example: Zoli, 2005; p. 2-6.

not have the possibility to control the inflation, in all the cases when the real interest rate is higher than the industrial production growth rate. Besides the theoretical implication of the achievement of interaction of the fiscal and the monetary policies through the intertemporal budget constraint in the fiscally dominant regime, empirical studies have not fully confirmed that these theoretical conclusions are justified. This is why Wyplosz (1999) and Favero (2002), when analyzing the said interaction within the EMU, conclude that the monetary policy in this situation does not follow the fiscal one, and that it even has the tendency to go in the opposite direction as a counter-reaction, i.e. that the price stability is being achieved despite the insufficient fiscal discipline which is sometimes manifested. However, even though Afonso (2002) in his empirical research has shown that the fiscal theory of price levels does not affect the EMU, the fiscal theory of price level finds another channel through which the central bank loses the option to affect the inflation level, even when the monetary authorities do not have the obligation to accept the pressure imposed by the fiscal authorities to lead an expansive monetary policy and achieve the necessary revenue resulting from seigniorage.

The other channel through which the macroeconomic theory explains the influence of fiscal policy over monetary policy is explained by the correlation between fiscal variables and interest rates, manifested in the fact that high fiscal deficits are correlated with the level of medium and long-term interest rates, that is to say, that the fiscal deficit and government debt affect the growth of interest rates. Compared to the previous one, the effects of this channel are object of a much broader consensus in the economic theory, and there are numerous empirical proofs which confirm them even at the EMU level. For example, Canzoneri et al. (2002) prove that the budget deficit and government debt have a strong influence over the interest rates in the Union.[3]

The next channel through which the influence of fiscal policy over the monetary one is achieved is the exchange rate, i.e. the exchange rate policy. Namely, the fiscal influence over exchange rates depends on the openness of the capital account of balance of payments, type of exchange rate and the country risk. In case of high capital mobility, flexible exchange rate and constant country risk, an expansive fiscal policy will lead to the temporary appreciation of the exchange rate, while in case of low capital mobility, fiscal expansion will lead to the depreciation of the exchange rate. Empirical confirmations of the effects of this channel are varied, while Beck (1993) and Caramazza (1993) confirm the existence of the connection, in developed economies, through fiscal expansion and exchange rate level. Certain authors have not succeeded in proving the existence of a strong connection between the mentioned concepts – McMillin and Koray (1990) and Koray and Chan (1991).

The influence of fiscal policy on the monetary policy is achieved through other channels, too. The character of fiscal policy is one of them. If the fiscal policy, due to its over-expansive character, represents a challenge to the price stability because of the economy overheating effect which develops as a consequence of such policy, it may in this case determine the nature of monetary policy, which has to act compensatorily if it is committed to price stability. Too high government spending, generous transfers and inefficient tax system are also the ways to influence monetary policy. The level of government debt may represent the channel through which the fiscal policy achieves influence over monetary policy, considering that there is a correlation between the government debt level and the levels of interest rates. In addition, a pronounced fiscal deficit, which raises expectations of increased revenues resulting from seigniorage, increases the need for monetary expansion which also determines a higher inflation.

Besides the entanglement and the interdependence of monetary and fiscal policies in the EMU, one of the reasons supporting the need to establish an adequate coordination of policies is the problem of externalities, which can be positive or negative in character, i.e. the cross-border policy spillover effects among member countries. This means that one country, depending on the way in which it handles its fiscal policy, may assist or hinder other countries.

As Alho (2001) notes, the national fiscal policy spillover effect depends also on the fact whether the demand channel or the supply channel dominate in the influence on taxes and inflation. If the increase in domestic taxes reduces the aggregate demand, the low inflation improves the domestic competitiveness, which then

[3] For detailed theoretical elaboration of the influence of fiscal policy on the interest rates levels, see: Dell'Erba and Sergio, 2013.

causes a decrease in foreign output and inflation. If, however, the increase in taxes cause a nominal salary growth, and a higher inflation hinders the domestic competitiveness, the effects on the output and inflation will be positive.

Namely, the way in which member states manage their fiscal policies is important for other countries as well, given that, because of the common monetary policy, the fiscal policy spillover effect through interest rates is very pronounced among the countries. This is especially true for the monetary union because there is a common financial market which facilitates the various spillovers of externalities from one country to another, emphasizing the importance of policy coordination.

There is number of different potential effects of fiscal policy spillovers, namely different channels through which the spillovers are produced. In the context of the monetary union, certain authors cite the following ones as the most relevant:

- Output spillovers: changes in the output in one country through export spillover in other member states through commercial channels;
- Price spillovers: the inflation in one country is transferred to another, through import;
- Competitiveness spillovers: price variation leads to relative price variation in the monetary union, through the competitiveness channels;
- Interest rates spillovers: in the monetary union, fiscal policy may cause the change in short-term interest rates, which will affect the output through interest rate channel;
- Exchange rate spillovers: exchange rate variations will influence the exchange rate in the monetary union, thus affecting the competitiveness of the country;
- Government debt spillovers: in the monetary union, government debt in one country usually affects the long-term interest rates in other member states (Plasmans, 2006, p.15).

Other authors recognize different ones, or focus on some of the abovementioned spillovers. Faini (2006) proves that the result of cross-border spillovers of fiscal policy in the EMU is not only the increase in the level of interest rates, but also the spread of interest rates, because the fiscal expansion which is connected to debt financing in the absence of the Ricardian equivalence, influences the increase of long-term interest rates in other states if they are integrated in the common capital market. Moreover, fiscal expansion in one national economy inside the monetary union pressures the domestic prices, influencing the common monetary authority embodied in the ECB to resort to a more restrictive monetary policy. This in turn influences the increase in the interest rates which concerns all member states. In addition, fiscal expansion in certain states may influence the appreciation of the Euro, which may result in disrupting the international competitiveness of the entire EU. Besides, if the deficits generated by an irresponsible fiscal policy in some countries are too substantial, they can pressure the ECB to loosen its monetary policy, which is also one of the spillover channels. The channel of the spillover is also related to the cyclical income spillovers among the member states. Business cycles are transferred through import and export because, in the expansion period characteristic of one country, the import from partner countries increases. This translates into the increase in export in the partner countries, that is to say the increase in income whose provenience is the country in the phase of expansion, which results in the synchronization of business cycles among the countries of the monetary union.

Finally, a new policy spillover mechanism is connected to the fiscal theory of price levels, according to which the central bank loses the option to control the prices because of the unsustainable fiscal policy of one country. In this context, the budget constraint becomes the condition of balance, because the adjustment of price levels helps harmonize the nominal value of the obligation of the country with the expected discounted value of its future primary surpluses. The prices are determined by the level of budget constraint in the Union, implying that the increase in the government debt in one member state brings about the inflation, if it is not accompanied by a tax increase in the subsequent period. Fiscal responsibility at the level of one state is no longer enough to guarantee price stability, that is, if other states behave in a fiscally irresponsible manner. Based on this, it can be concluded that the monetary union may even strengthen the effect of cross-border fiscal policy spillover effect.

The results of empirical studies best show the importance of the negative externalities and fiscal policy spillover effects among the member countries of the Union, and consequently the importance of establishing an adequate coordination mechanism for the monetary and the fiscal policies, and within the fiscal policy.

The principle is – the greater the spillover degree between monetary and fiscal policies, the more pronounced the need for coordination. This principle is especially true in the context of the EMU, in which the national economies pursue their fiscal policies separately, which strongly influences the economic activities and inflation tendencies, demanding an adequate reaction of the centralized monetary authority.

Canova and Pappa (2007), based on the example of 9 Union members, analyze the influence of fiscal disturbances (shocks)[4] on price differentials that represent a threat to price stability. The results of the research show that fiscal policy, in the statistical sense, is a significant source of price differential responses. Regardless of the fact that most of the influences of fiscal disturbances vary according to the type of shock (different fiscal instruments have different quantitative effects), on an average they are used to explain from 14% to 23% of price differential responses. Government expenditure shocks influence 21% responses, while government revenue shocks influence 14% price differentials. There certainly are differences among the countries: in some of them, as much as 40% of price differentials are the outcome of individual types of shocks. Research results are significant because they attest to the high statistical influence of the different types of shock on price differentials, and consequently on the price stability with the EMU. This confirms the importance of establishing an adequate macroeconomic coordination[5], as seen in Figure 1:

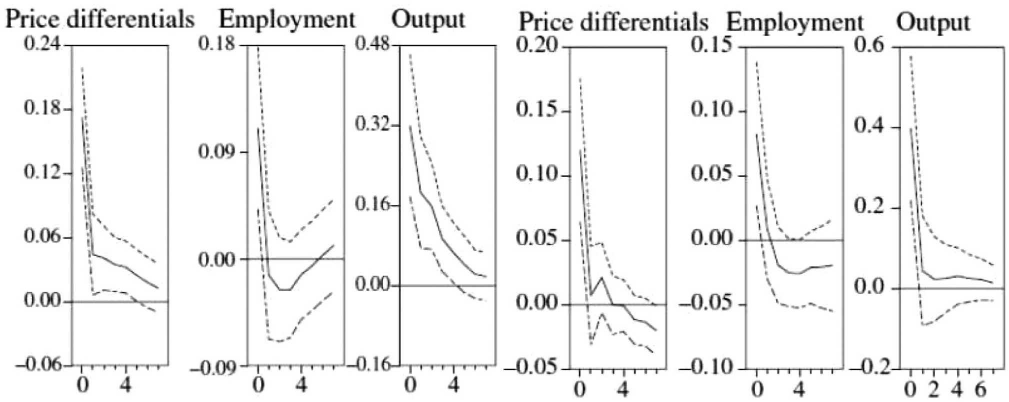

Figure 1: Average influence of government spending shock and government revenue shock on price differential, employment and output

Source: Canova and Evi, 2007; p. 726.

There is a significant level of other empirical research done in the context of the EMU, measuring the intensity of fiscal spillovers related to the influence of the changes of national fiscal policies on the economic growth in other member countries. Accordingly, Beetsma et al. (2006) prove that the average effect of 1% fiscal stimulus of the GDP in Germany is a 0.23% growth (of foreign GDP) for the increase in spending and 0.06% for net tax decrease, over two years. That is to say, the increase of government spending (net tax reduction) for 1% of Germany's GDP causes the increase of 0.4% in Austria, Belgium, Luxembourg and the Netherlands, by the end of the two years' period. Fiscal spillovers which concern France are slightly smaller, but nonetheless cannot be ignored. It is also concluded that the effect of the domestic fiscal impulse which amounts to 1% of the GDP results in a cumulative increase in the export of trade partners in the amount of 1.4% in the case of government spending shock, or 0.3% in the case of net tax shocks.

[4] The research takes into account two types of fiscal shocks – government spending shocks and government revenue shock. The first one is financed either by the emission of bonds (G shock) and produces a positive impact on the national output and deficit, or by distortive taxation (BB shock) which leaves the deficit unchanged and reduces the output. The latter type of shock is related to government revenue (tax reduction) (T shock) and it negatively influences the national deficit and the national output.

[5] For more details on the model and the results of the study, see: Canova and Evi, 2007; p. 722-734.

On the other hand, Bénassy–Quéré and Cimadomo (2006) have proven that there are positive cross-border spillovers from Germany, especially on the neighboring countries and smaller states. The research has shown that the tax multiplier is greater than the spending multiplier, and that the tax shocks effect on the output is more durable.

The amount of cross-border fiscal spillovers analyzed in the empirical studies represents one of the more solid arguments supporting the establishment of the appropriate mechanism of coordination between monetary and fiscal policies in the EMU.

4. Coordination tendencies inside the European Monetary Union

Taking into account the specificity of the EMU reflected in the single monetary policy on the supranational level and the common currency, the national fiscal policies that are within the competence of Member States, and the interdependence of its members, the coordination of economic policies stands out as a prerequisite for its proper functioning. Otherwise, the problems of negative externalities and spillover effects of the economic policies among the member states would increase so much that they would compromise the EMU's stability in the economic and political terms. In this sense, the legal basis for the coordination of economic policies within the EMU is contained in the Maastricht Treaty, which obliges the Member States to regard their economic policies as policies which are of the common interest for the entire Union, which is why an appropriate coordination mechanism has to be set up. Besides defining the financial rules that are elaborated in more detail later on in the Stability and Growth Pact, the strongest mechanism for coordination of economic policies, the Treaty also introduces the need to draft the Broad Economic Policy Guidelines. The Guidelines, adopted by the Council, consist of general recommendations for policy makers in the Member States, and based on them the conformity assessment of the economic policies of the Member States with the principles defined in the previously adopted guidelines is carried out.

The Broad Economic Policy Guidelines stem from the inclination towards coordination and the screening of national economic policies, and are the result of the consensus reached based on the economic policy analysis[6]. They are important because they treat both the macroeconomic and the structural policies, thus giving a complete overview which contributes not only to a more consistent management of a range of policies, but are also a platform for the subsequent control of the observance of the Guidelines by the Member States. They are classified as legally non-binding acts (they do not provide a sanctioning mechanism in case of non-compliance), given that they are adopted in the form of recommendations, which gives them political, and not legal significance. This is not due only to the fact that they are adopted by the Council (formally prepared by the ECOFIN based on the recommendations of the European Commission), but also because the EU Member States are in some ways bound to respect them through the Open Method Coordination.

The guidelines provide an institutional framework for the implementation of the Lisbon Strategy adopted in March 2000, which regulates the implementation of the economic, social and environmental reforms by 2010. Since they are general guidelines, they are the result of specialized mechanisms related to certain types of policies, which is why they hold a central position when it comes to the mechanism of coordination of economic policies within the Union, as shown in Figure 2:

[6] Article 121 of the Treaty on the Functioning of the European Union (TFEU).

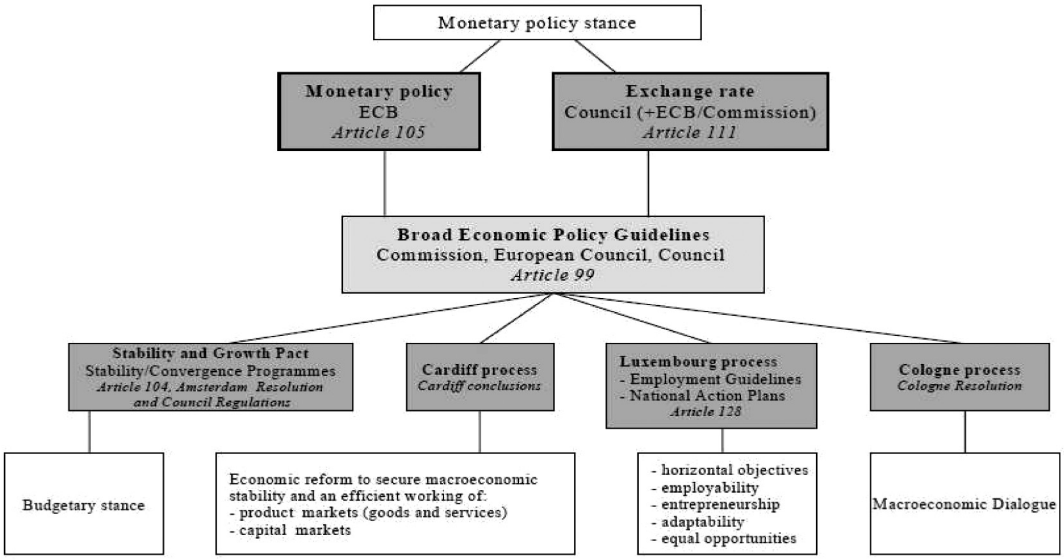

Figure 2: Coordination of economic policies which require dialogue with the ECB
Source: European Commission, http://ec.europa.eu/economy_finance/publications/publication1022_en.pdf 2002; p. 6. (Accessed – 01.09.2014.)

In the Lisbon strategy reform conducted in 2005, there are minor changes in the indicated structure for the coordination of economic policies represented by the establishment of the Integrated Guidelines for Growth and Employment, which combine the Broad Economic Policy Guidelines with the Employment Guidelines. The Integrated Guidelines oblige every Member State to develop the National Reform Programme for the next three years, containing the key priorities of economic reforms, the planned reforms and the objectives the Member State aims at. Based on the Integrated Guidelines and the National Reform Programmes, the Commission adopts the Annual Progress Report in December.

The Global Economic Crisis and the macroeconomic disturbances it provoked underlined the need for a stronger and more comprehensive coordination of economic policies of the Member States in relation to the harmonization of processes and goals of the national budgetary policies, as well as the growth and employment policies. In fact, the economic crisis has brought to date several conclusions which influenced further reforms of the economic management in the EU:

- The Euro zone is facing a lack of an institutional framework for the identification and correction of macroeconomic imbalances;
- Implementation of the Stability and Growth Pact did not contribute to the consistency of fiscal policies in the monetary union;
- The lack of adequate mechanisms of coordination of economic policies that are essential for a competitive and sustainable economic growth;
- Financial monitoring lagged behind financial integration;
- Challenges related to government debt in some Member States can endanger the stability of the entire Euro zone (Constancio, 2011, pp. 1-3).

This is why the reform of the economic policies coordination, i.e. the economic governance in the EU was initiated. Adopted in June 2010, the new ten-year Europe 2020 Strategy, in addition to establishing three priorities related to smart, sustainable and inclusive growth and a series of sub-goals in function of said priorities, recognizes very clearly the need for a stronger coordination of economic policies within the economic and monetary union. The recent crisis has highlighted the increased level of interdependence, especially in the financial sector, thus making the careful consideration of spillover effects between countries even more important. This was complemented by the tendencies related to divergent trends in the economic growth among countries, as well as to cases of accumulation of unsustainable levels of government debt which are a pressure on the single currency. The crisis has thrown light on the challenges present in the Euro zone, particularly those that are related to the sustainability of government finances and the potential economic growth, as well as on the destabilizing role of imbalances and various divergences related to competitiveness. Dealing with these challenges requires a stronger coordination of economic policies in order to establish a framework for a more efficient monitoring of the Member States, which should result in strengthening the fiscal discipline and the preservation of the financial stability of the Euro zone.[7]

This was the reason for the establishment of the European Semester, starting in January 2011, as a new instrument of control and coordination of economic and fiscal policies of the Member States, named in this way because most of the coordination is performed in the first six months of the current year. It has been recognized in the Six Pack as a mechanism for improving the coordination, through the harmonization of the budgetary and general economic policy objectives, previously agreed at the EU level, done by the Member States, in order to ensure the sustainability of government finances, encourage economic growth and prevent the occurrence of excessive macroeconomic imbalances. Unlike the previous approach which relied on the subsequent evaluation and correction, the point of this mechanism is that the recommendations and early warnings are given in advance.

The European Semester essentially rests on three pillars. The first pillar refers to the coordination of economic policies through the Europe 2020 Strategy and the Integrated Guidelines, containing the Broad Economic Policy Guidelines and the Employment Guidelines. The second pillar is connected to fiscal policy coordination, i.e. the Stability and Growth Pact, and it includes preventive and corrective measures. The third pillar is based on macroeconomic control, and it also includes the preventive measures through the monitoring of several indicators, as well as the corrective measures containing an appropriate procedure in case of excessive imbalances. The procedures envisioned by the European Semester are shown in Figure 3:

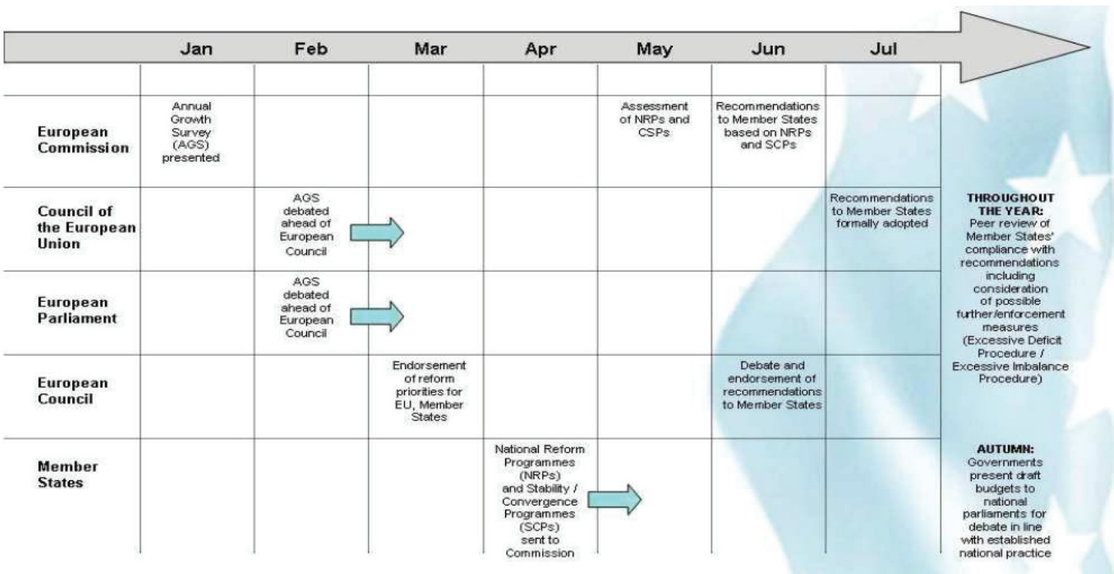

Figure 3: Procedure envisioned by the European Semester
Source: European Commission, http://ec.europa.eu/europe2020/pdf/chart_en.pdf, (Accessed – 01.09.2014.)

Finally, the economic policy coordination mechanism in the EMU was further improved by the adoption of the European Plus Pact in March 2011. This mechanism aims to improve the competitiveness and enhance the economic policy coordination through a greater degree of convergence. It has several functions – promoting competitiveness, promoting employment, ensuring the sustainability of government finances and strengthening financial stability (Degryse, 2012, pp. 45-47).

[7] For more details regarding the contents of the Europe 2020 Strategy, see: European Commission, 2010.

It is important to bear in mind that the Council established the European Stability Mechanism - ESM in March 2011, which became effective starting from September 2012, with the aim of providing financial assistance to the Euro zone Member States necessary to maintain their financial stability. It is expected that its lending capacity of 500 billion Euros will be enough to enable the fulfillment of the objective for which it was established. It represents a key assistance instrument for the Euro zone members – all members of the European stabilization mechanism - which have trouble accessing the financial markets. Actually, the European Stability Mechanism has replaced the previous two temporary mechanisms - the European Financial Stabilization Mechanism – EFSM and European Financial Stability Facility – EFSF.

Therefore, the framework for the coordination of economic policies within the EU was finally completed with the implementation of the Euro Plus Pack, the Treaty on Stability, Coordination and Governance, as well as the Six Pack, the Two Pack and the Fiscal Pact.

5. Possible directions for the development of coordination

The establishment of a new framework of economic management, that is to say, of new instruments of control and coordination of the fiscal or economic policy within the EU, responds to:

- The problem of negative externalities or spillovers between Member States, which has become more apparent after the latest crisis outbreak;

- Lack of institutional framework for the correction of macroeconomic imbalances, required not only for the proper coordination of the monetary and fiscal or the economic policy in general, but also for the implementation of mechanisms that arise as a result of the aforementioned coordination.

In this sense, it is expected that the Euro Plus Pack, the Six Pack and the Fiscal Pack will reinforce the fiscal discipline and improve the economic management; that the European Financial Stabilization Mechanism and the European Financial Stability Facility, i.e. the European Stability Mechanism that replaced them in 2011, will improve the crisis management within the EU, while the European Semester will significantly improve the coordination of economic policies within the Union.

Essentially, there are three key innovations contained in the European Semester as the basic mechanism of coordination of economic policy, with respect to the procedures foreseen by the previous coordination mechanisms:

- The issue of the monitoring and the prevention of imbalances is significantly expanded: fiscal imbalances, such as government debt and fiscal deficits, are not the only ones taken into account, but there is also a number of other macroeconomic indicators related to overall macroeconomic imbalances;
- The binding character of monitoring in the event of fiscal or macroeconomic imbalances is strengthened: sanctions in the form of interest-bearing or non-interest bearing deposits that can be converted into fines;
- Improvement of the ex ante monitoring: stability assessment and convergence programmes are carried out before making the key decisions related to national budgets (Degryse, 2012, p. 39).

Therefore, the European semester should guarantee the efficiency of ex ante coordination of economic and budgetary policies within the EU, in the following ways:

- Strengthening the role of European institutions, through the commitment of Member States to present their budget plans before they are formally proposed to the national parliament;
- Prescribing the obligation to obtain the approval of any fiscal and structural reform by the relevant institutions at the supranational level;
- Creating conditions for the sustainability of national budgets.

In essence, the new system is a step forward in the prevention of serious macroeconomic disturbances with respect to the planned monitoring of a variety of indicators and the presence of excessive macroeconomic imbalances, through the appropriate reporting of the European Commission. In addition, the importance of the monitoring of the government debt and government finances in general is increased, through the obligation of obtaining the consent at the supranational level, which has not been the case so far.[8]

However, no matter how great the expectations of the European Semester as the new instrument of control and coordination of fiscal or economic policy, now, several years since the initiation of the new coordination framework, there are relevant analyses which point to its flaws.[9] These gaps, at the same time, represent a challenge for the coordination of macroeconomic policies in future.

In line with what has been said, the new coordination frameworks, as comprehensive as they may be, are not sufficient to provide the formal establishment of better coordination, given that they are not binding and are a key mechanism for ensuring the application of political pressure by the relevant EU institutions. In this regard, it is likely that the absence of an approach that would ensure the implementation of the recommendations given by the European Commission to the Member States may be one of the decisive factors to determine that the objectives for which the European Semester was established in the first place will not be achieved completely.

In addition, the lack of adequate sanctions for the failure to implement the recommendations, as well as the inability to prevent the dilution of recommendations given to Member States by the Council is another problem of the latest reforms. This happens because of the same problem that occurred in the application of the Stability and Growth Pact. In fact, despite the awareness of the European Commission that there is a need for stronger coordination of the fiscal policy, and the understanding that it is necessary to make a departure from the so-called One Size Fits All approach, the actual process of political decision-making that takes place at the level of the Council reduces the impact of the European Commission, in spite of the improvements envisioned by the Six Pack. The Council may also often dilute the previously prepared recommendations.

It is pointed out next that the problem of the reform is that it relies on previously exhausted methods of hard and soft policy coordination. On one hand, the current application of the Stability and Growth Pact, based on solid fiscal policy, showed that the pact was not able to prevent the conduct of unsustainable fiscal policies, while the new approach, based on the European Semester and the Euro Plus Pact and their principle of soft coordination, is criticized for the absence of tools which would ensure its implementation.

It is further noted that the implementation of new mechanisms has made the already complicated economic governance and coordination of economic policies within the Euro area even more so. This could also, according to Verhalstu (2013), be one of the factors that will hinder the proper application and fulfillment of the objectives of the reform, reducing therefore the effectiveness of coordination. Instead, it is possible that it would be much better to ensure the implementation of existing instruments and tools, without further complicating it.

A challenge is also present in the form of the political influence within the Council, which is manifested in the fact that it may be possible that the recommendations prepared by the European Commission differ from the final version adopted by the Council at the end of the cycle.

Further post-crisis developments within the Union, which in principle may go in three different directions, are also one of the factors that may determine the future coordination of economic policies. For the time being, it would appear that the opinions based on a greater and deeper integration prevail. In this context, it can be expected that in the time span of at least 5 years a banking and a fiscal union should be created. A unique monitoring mechanism, which will start in its full capacity in 2014, will open up new possibilities for monetary policy in the Euro zone, which is why it is realistic to expect a better interaction between the monetary, supervisory and regulatory policies within the EU.

[8] See, for example, Praussello, 2012; p. 187-197.
[9] See, for example: Maidla, 2012.

Although there has not been enough willingness to create a united or federal Europe, the recent developments have brought to date the question of a fiscal union which would certainly determine the way to coordinate the economic policy. In this sense, there are a few suggestions concerning the direction in which the future union could be constituted. One option is represented by an interregional fiscal transfer mechanism, as a kind of insurance against asymmetric shocks (Dullien and Schwarzer, 2005), the increase in the EU budget in order to establish a horizontal mechanism for fiscal equalization (Italianer and Vanheukelen, 1993, Hammond and von Hagen, 1998) and the introduction of Eurobonds with the support of all EU Member States (De Grauwe and Moes, 2010; Favero and Missale, 2011). The second direction is essentially a return to the old way of coordination that relies on the gradual coordination based on a voluntary basis. The third is related to the possible disintegration of the EU either by the individual Member States voluntarily leaving the Union, or by them being expelled by others. Despite the direction of the further processes within the EU, each of these scenarios would significantly contribute to changing the mode in which the monetary and fiscal policies, or the economic policy in general, are coordinated.

Conslusion

The advantages of coordination of monetary and fiscal policy in EMU are numerous, and are usually associated with the prevention of the aforementioned cross-border spillovers and negative externalities which the monetary union faces, a situation which leads to non-optimal effects of economic policies. In this sense, the first advantage of coordination is surely the prevention of negative externalities related to the interest rate channel. What is more, the advantage of coordination of economic policies is manifested through the preservation of the stability of the Euro as the common currency, which would most likely be compromised in the event of its absence, which in turn would seriously jeopardize the competitiveness of the EMU. The advantage of coordination lies also in the fact that it helps the implementation of policies at the national level, because were it not for the supranational “pressures”, some short-term costs associated with certain policies which need to be implemented would be blocked. Finally, the benefits of coordination are also reflected in the prevention of the policy spillover mechanism that relies on the fiscal theory of the price level, according to which the central bank loses its ability to control prices if the fiscal authorities pursue an irresponsible fiscal policy. Consequently, it may be concluded that the coordination is a precondition of price stability, and that the establishment of price stability in the medium term is in turn beneficial for other economic performances, i.e. the economic growth, investments and employment.

The answer to the shortcomings which, after the crisis, become more obvious and pronounced is certainly represented by the new framework for economic governance, and its new instruments of monitoring and coordination of fiscal or economic policies within the EU. The instruments of monitoring and coordination are the result of the absence of an institutional framework for the correction of macroeconomic imbalances, necessary for the proper coordination of monetary and fiscal policies. The European Stability Mechanism will improve the crisis management in the EU, while the Euro Plus pack and the European semester, as the new instrument of the monitoring and coordination of economic policies, will significantly improve the coordination of economic policy, despite the existence of vulnerabilities that became evident shortly after the beginning of its implementation.

The European Semester – whose main point, unlike the previous approaches that operated on the principle of subsequent evaluation and correction, is to give recommendations and early warnings in advance – rests on three pillars. The first one is related to the economic policy coordination through the 2020 Strategy and the Integrated Guidelines, the second one is related to the coordination of fiscal policy and the Stability and Growth Pact, while the third one is based on macroeconomic control. However, in addition to positive effects, it can already be noted that there are omissions in the new monitoring and coordination instrument of the EU, which mainly refer to the casualness in the implementation of recommendations, the inadequate sanction mechanism in the case of implementation failure, additional complication of an already complicated process, the political influence of the Council, and so on.

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