

# Disciplining Device or Insurance Arrangement?

## Two Approaches to the Political Economy of EMU Policy Coordination

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*Abstract:* This paper reviews the ongoing debate on the EMU policy framework and discusses two approaches to policy coordination. The Stability and Growth Pact follows the disciplining view by enforcing one-sided adjustment of countries in fiscal difficulties. This is meant to achieve credibility at the cost of flexibility. Alternatively, policy coordination may be devised as an insurance arrangement to increase the effectiveness of fiscal stabilisation. This insurance view has traditionally neglected political economy considerations. I argue, however, that the approach can be amended in this respect. It would then support reforms that are in line with earlier and present Commission proposals.

*Key words:* policy coordination, EMU, Stability and Growth Pact, credibility, insurance, logic of collective action

## ***1 Introduction***

The debate on the framework of EMU policy coordination is still on. In May 2002, a Commission proposal which suggested to give it a leading role in coordinating fiscal policies has been rejected by finance ministers, reportedly above all by the French, the German and the British office holders (European Commission 2002a; FAZ 2002). The Commission has responded by sending this proposal for further consideration to the convention on a future European constitution. At the end of November, the monetary and financial affairs Commissioner Pedro Solbes suggested some fundamental reforms, such as differentiating between countries with high and low levels of public debt. This row indicates that the institutionalisation of EMU policy coordination is still in a state of flux and that EU policymakers perceive shortcomings that call for reform. In the academic debate on how much and what form of economic policy coordination EMU needs, two camps can be distinguished. The supporters of the Pact apply what have become standard Political Economy arguments concerning the credibility of economic policy. Governments' ability for fiscal intervention has to be constrained in their own interest and rules that ensure medium-term fiscal consolidation are essential for the functioning of a currency union.<sup>1</sup> The critics of the Pact argue on the basis of old and new macroeconomics that one should not constrain governments' flexibility in fiscal policy just when unification of monetary policy has eliminated the capacity for setting country-specific interest rates. Moreover, in these models prices and wages will not, and possibly should not, become flexible enough to compensate for an imminent loss of macroeconomic policies.<sup>2</sup>

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<sup>1</sup> Giavazzi and Pagano (1988) is the seminal paper on 'the advantage of tying one's hand' by rules, Artis and Buti (2000, 2001) are strong recent defences of the SGP based on this view.

<sup>2</sup> See for instance Buiter et al (1993), Eichengreen and Wyplosz (1998), Obstfeld and Peri (1998), and Canzoneri, Cumby and Diba (2002) for a critique implicitly or explicitly based on the acknowledgement of market imperfections.

While the arguments of either side have merit, a worrisome political paradox seems to have escaped most participants in that debate. EMU policy coordination has arguably been designed in line with the disciplining view and thus aims at tying governments' hands to prevent the misuse of fiscal policies. Yet if political authorities are always on the verge of doing what the disciplining view suspects them to do if unfettered, European monetary integration has been an irresponsible undertaking to begin with. It would amount to an ongoing conspiracy against European citizens. The paradox is that present arrangements try to ensure sound and thus legitimate policies, yet they are based on assumptions about policymakers that make EMU an illegitimate undertaking.

The insurance approach that I propose instead does not rely on assumptions that only Eurosceptics would share. An insurance arrangement tries to make stabilisation more effective in two ways: on the one hand, by pooling risks and, on the other, by diverting special interests originating at the national level. The latter feature is a tribute to insights of the disciplining view, namely to take political economy considerations seriously. If thus amended, the insurance approach provides guidelines for reform on both macroeconomic and political economy grounds.

The paper proceeds as follows: In the next section, I try to motivate the need for reform empirically by reviewing first experiences with the workings of the EMU policy framework, namely the surveillance procedure as applied to the fiscal situations in Ireland in 2001 as well as Germany (and Portugal) in 2002. This is to show that the present framework follows the disciplining view, the underlying assumptions of which are analysed and criticised in section 3. Next follows an outline of policy coordination as an insurance arrangement. In section 5, I explore how both views take the influence of special interest groups on policy making into account and how policy coordination is meant to deal with it. Section 6 points out how earlier and present reform proposals by the

Commission fit into an insurance approach to EMU policy coordination. The conclusions sum up.

## ***2 EMU policy coordination in practice***

EMU policy coordination was arguably tested twice so far, namely when the Irish government got a reprimand in 2001 and when Germany along with Portugal escaped an early warning in 2002. This brief review suggests, first, that the present framework is tilted towards operating as a disciplining device, and, second, that these two instances exposed well-known problems of the EMU policy framework that warrant amendments. The first test of the EMU policy framework was one for its soft method of coordination. In February 2001, the Irish government's plans to lower taxes was seen to be overly expansionary, inconsistent with the Broad Economic Policy Guidelines (BEPG) previously accepted for and by the country in the Council. Ireland's very high and sustained growth had led to rising wages and housing prices that were driving the increase in its measured price level to 5.6% in 2000, more than twice the EU average of 2.3% for that year. Consequently, the Ecofin Council<sup>3</sup>, upon recommendation by the Commission, issued a reprimand, or 'recommendation', asking Ireland to make its budgetary plans consistent with the guidelines. Yet, this only hardened the Irish government's commitment to these plans (Financial Times 2001). It made some adjustments only later that year which went largely unnoticed in the media. The government pointed out that even with its expansionary tax policies, it still had a budget surplus. Moreover, it had a slight current account surplus which might indicate that the economy's earnings and price level was simply about to catch-up with the rest of Europe. The Irish case revealed several weaknesses of the soft coordination framework. First of all, the Irish government's response made it plainly obvious that the guidelines can ultimately not be enforced. Moreover,

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<sup>3</sup> The *European Council of Economic and Finance Ministers* which is the body that ultimately authorises each step of the surveillance mechanism.

insisting on these soft rules was politically counterproductive, arguably contributing to the outcome of the Irish referendum on the Nice Treaty later in that year. Last but not least, the Commission and the Council had a hard time to convince the public that the Irish budget was an immediate threat for price stability in the euro zone. All the rhetoric of sound, stability-oriented fiscal policy focuses on the 3% deficit criterion – so why censure a country with a surplus that is too small an economy to induce an EMU-wide inflationary process? At least to sceptics, the Irish censure sent the message that soft policy coordination is politically unpopular and economically futile.

The second test was reserved for the hard rules of policy coordination. Germany ran a budget deficit of 2.6% in 2001 and was forecast to have one of 2.7% in 2002. Thus, the regulations of the SGP left the Commission no choice but to invoke the early warning mechanism (Cabral 2001: 143). It asked the Ecofin Council to issue a reprimand to the German (and the Portuguese) government. The German government in turn used all political means to avoid this, notably with the public support of a non-participating member state, the UK, whose finance minister wants the budget deficit to be measured in purely structural terms.<sup>4</sup> In return, the government promised to fulfil its promise to reach a balanced budget by 2004 even more stringently than it thought possible before and to conclude a national stability pact with the German Laender to rein in deficits at the regional level.<sup>5</sup>

The Commission had been following the rules when it recommended to issue an early warning. Yet, the decision in the Council *not* to follow the Commission's recommendation was unanimous. Even the ECB was

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<sup>4</sup> As Gros (2002) rightly points out, however, even a structural deficit criterion could hardly serve as an excuse. In 2000, when German growth was arguably above average, namely at 3.0%, the budget still showed a *deficit* of 1.2% while it should have run a structural *surplus* of roughly 0.3%. – Portugal was also spared a reprimand but most commentators noticed that only in passing.

<sup>5</sup> As can be read on the homepage of the German government at URL: [www.bundesregierung.de/dokumente/Artikel/ix\\_69465\\_2710.htm](http://www.bundesregierung.de/dokumente/Artikel/ix_69465_2710.htm)

surprisingly relaxed or, as usual, publicly ambiguous as regards the outcome of the controversy between the Schroeder government and the Commission (Financial Times 2002; Soskice and Hancké 2002). This indicates that the early warning mechanism of the SGP provides little guidance for how to go about policy coordination. It inevitably puts a stark choice before policymakers: credibility may have to be sacrificed for macroeconomic stability or vice versa. But despite the apparent sacrifice of credibility in this case, financial markets did not react, i.e. the euro exchange rate did barely move and slightly appreciated against the US-dollar and the Pound afterwards. Financial market analysts were quoted that nobody wants the EMU recession to deepen just because SGP rules would require the German government to follow pro-cyclical, recessionary policies. We will see that there could hardly be a harsher criticism of the rationale for a disciplining device. Once again, the incidence revealed serious weaknesses of the present arrangements and possibly resulted in a “lose-lose” situation for the Commission and the governments involved.<sup>6</sup> These cases reveal three elements of present EMU policy coordination that characterise it as a disciplining device for individual member states. I summarise for each element why this may be problematic:

1. Present coordination targets only individual country's performance, not the aggregate. From an EMU point of view, policy coordination for the euro zone requires to target the aggregate stance, complementary to monetary policy so as to get the right policy mix. In the Irish case, there were already signs of a downturn in the euro area (European Commission 2002b: 11) and expansionary impulses would have been welcome. But looking at the national case forced the Commission to ask for censure. The German case was just the mirror image of the Irish

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<sup>6</sup> Gros (2002).- In a thought-provoking paper, Soskice and Hancké (2002) interpret the reprimand for Ireland and the compromise on Germany as being consistent in that each time Ecofin was only concerned about inflationary fiscal policies. The interesting question then is why Portugal escaped an early warning. Portugal's policy stance has been at least as inflationary as Ireland's. It is hardly a sign of consistency if Portugal was let off the hook just because there was a good reason to let Germany off.



one. The growth performance of Germany slowed down recovery in the euro zone already, yet the rules of the SGP called for more of the same. This is problematic from an economic point of view.<sup>7</sup>

2. Present coordination proceeds via (the threat of) imposing additional costs on a country so as to make non-compliance costly. In most cases these costs consist mainly of the blame and shame for a government. The Irish response indicates the precarious effectiveness of this peer reviewing. The country's situation was very comfortable but the reprimand was not taken lightly. Its government could self-confidently reject the censure because its policy of tax cuts was popular with an electorate that suspected other countries to be jealous of its economic achievements. The German case was exemplary for what is to be expected in situations where the excessive deficit procedure applies. The government tried very hard to avoid a formal reprimand. This seems to have been popular even in a country where the public had traditionally been supportive of stability-oriented policies. Thus, whenever the sanctions apply, they are likely to stir anti-European sentiments in the country concerned. This is problematic for political integration.
3. Present coordination seeks to impose an automatism by applying the same rules and quantitatively specified criteria to each country. In this way, governments tie their hands both *to* stability-oriented policies but also as regards *the use of* stabilising policies. The present framework has built in some flexibility by asking the Ecofin Council to decide on every next step in the prescribed procedure.<sup>8</sup> Arguably, however, the

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<sup>7</sup> Cf. Demertzis et al (1999). But see Artis and Buti (2000) and Collignon (2001) for a more benign view – the SGP is geared to determine the aggregate fiscal stance, namely in the steady state where it is zero or in surplus. I doubt the usefulness of rules for policy coordination that work only in the steady state.

<sup>8</sup> Cf. Cabral (2001: 148). See also Lohmann (2000) for the ingenious idea to apply the engineering concept of *Sollbruchstelle*, i.e. the part of a machine that is supposed to take the hit when the machine comes under stress, to monetary institutions. Analogously, it is that element of an institution that provides for flexibility in the face of deep uncertainty.

automatism that has to be sanctioned by political decisions worked in neither case. It was either ignored by the country or suspended by Ecofin's decision, respectively. In an election year the Irish government wanted to redistribute some of the benefits of sustained growth by way of a tax reduction. And the German government was not inclined to deepen a recession in an election year when it could plausibly make the case that not all of that recession was its own fault but aggravated by external shocks. To ask governments to stick to automatism is asking them for something close to committing political suicide. In political economy perspective, this is a problem because it invites defection. These three elements, i.e. focus on national budgets, regressive burden-sharing and politically sanctioned automatism clearly indicate that the Pact is a disciplining device in contrast to a stabilisation arrangement. A stabilisation arrangement would be geared to get the right policy mix in EMU, i.e. aim at an *aggregate* fiscal stance complementary to that of a unified monetary policy. Moreover, the insurance element of collective stabilisation would show up if policy coordination provides for actuarially fair burden-sharing and for a case-by-case evaluation by a body mediating between the insured and the insurers.

### ***3 EMU policy coordination as a disciplining device***

The history of macroeconomic policy coordination in Europe - from the pegged exchange rate system of the EMS to the SGP – can be reconstructed as a successive implementation of disciplining devices. Such devices are considered necessary if macroeconomic policies of participating governments have a 'credibility' problem. After an outline of the general idea and how it may explain European monetary integration, I will show that for a credibility problem to arise a set of rather specific conditions has to be fulfilled.

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In section F, I will discuss the rationale of the Pact's political prerogative in the insurance view.

### 3.1 Credibility problems of macroeconomic policy

A credibility problem of macroeconomic policy arises when a government is believed to change a policy, at present planned for the future, as times goes by.<sup>9</sup> The notorious example for such a credibility problem is monetary policy by a central bank that cares not only about price stability but also about employment. She has reason to choose a positive inflation rate to optimise both objectives if the economy exhibits an inflation-unemployment tradeoff and if her employment objective is more ambitious than what market forces would attain on their own. These preferences of the central bank are known, perfectly or imperfectly, by the public. From the central bank's point of view, it would be best if the private sector, say wage bargainers, would believe in a zero inflation policy and set nominal wages in line with those expectations. A slight increase in unexpected inflation would then lead to more employment which the central bank prefers. If the public knows about this incentive, the wage bargaining parties set nominal wages according to their rational expectations of positive inflation. The economy thus ends up with higher inflation but no gain in employment above the natural rate which is sub-optimal from the central bank's point of view.

More generally, the inducement to revise a plan stems from the authorities' policy preferences being different from those of the representative private agent. For instance, the goals of employment and price stability may have different weights or the discount rates may differ in the respective objective functions. Dynamic inconsistency then occurs because the government would benefit from a revision of policy whenever the private sector acts according to the government's plans as presently stated. Yet, this incentive of policymakers is rationally expected by the private sector and therefore the policy becomes incredible under perfect

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<sup>9</sup> The seminal article is Kydland and Prescott (1977). Barro and Gordon (1983) applied it to monetary policy, Giavazzi and Pagano (1988) to the EMS. For an excellent textbook treatment, see Cukierman (1992, in particular chapter 11).

information or less than credible under imperfect information.<sup>10</sup> What is more, not only do the authorities not succeed, but the economy ends up in the worst of all possible worlds. That is why the authorities then decide to change their ways and tie their hands. Credibility of a stability-oriented policy is necessarily gained at the expense of flexibility (Bronk 2002: 23-27).

### **3.2 European monetary integration as a solution to credibility problems**

The way out of such credibility problems is precommitment or 'tying the hands' of monetary policy to make announcements of a stability-oriented policy (more) credible. Giavazzi and Pagano (1988) were the first who applied this idea to policy coordination in Europe. They interpreted the EMS as a disciplining device. The pegging of exchange rates presumably required them to maintain inflation rates in line with that of Germany whose central bank had a credible low inflation stance. The political cost of devaluation amounts to a self-imposed fine and thereby prevents the temptation to inflation surprises (Cukierman 1992: 24-25). From hindsight it seems, however, that the pegging of exchange rates in the EMS was a less than fully effective disciplining device. Realignment occurred repeatedly and in each single realignment the German mark was revalued.

In this reading of history, EMU solved the perennial credibility problem of EMS member states' monetary policies in the most radical way, namely by unifying monetary policy. Unlike any of the central banks it replaced, the ECB is legally obliged to care for price stability only. However, seen from this perspective which assumes unchanged preferences of policymakers, EMU's considerable success in forcing inflation rates to downward convergence came at the cost of shifting the credibility problem to national fiscal policies. Given that they still have preferences for 'super-natural'

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<sup>10</sup> Imperfect information between the public and policymakers gives rise to a reputation mechanism which dampens the temptation to inflationary or expansionary policies (Cukierman 1992: 5).

employment levels, governments use integrated financial markets to incur higher debts for expansionary policies. The interest rate costs are presumably lower because that government's debt is now a smaller share with respect to the enlarged capital market. And profligate governments may believe that lenders perceive the monetary union as an implicit bail-out guarantee by the ECB or other governments and thus do not charge country-specific risk premia. But if several countries act on that basis and engage in debt-financed fiscal expansion, Euro interest rates would go up and punish even those members that played by the EMU rules.

The disciplining rationale of the SGP is analogous to that of the EMS. It acts as a deterrent to over-expansionary fiscal policies by making governments commit to the political cost of blame and shame imposed by the early warning mechanism and to the economic cost of ultimately even paying a fine. Therefore, breaching the 3%-budget deficit- limit presumably occurs only under extreme circumstances like a deep recession. This provision also signals a no-bail out clause to the financial markets. Fiscal policy coordination under the SGP is geared to ensure at each moment a fiscal policy of individual governments that provides for a balanced budget in the medium term.

### **3.3 Problematic assumptions of the disciplining view**

The theory of policy coordination as a disciplining device is not based on a common sense understanding of credibility. Models that explore credibility problems rely on rational expectations in a methodological sense, i.e. actors in the model share a knowledge about the workings of the model, for instance about the policy preferences and instruments of government, and form expectations by exploiting this knowledge.<sup>11</sup> The following two

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<sup>11</sup> The basic assumptions originated in the new classical theory of economic policy, prominent proponents of which were Lucas (1972) and Sargent and Wallace (1975). The premise of rational expectations, i.e. expectations consistent with the respective model, seems to me legitimate as a methodological test that any model has to pass, namely to abstain from assumptions about expectations that are not justified by the model itself. It is problematic, however, to draw straightforward policy conclusions from such models

sets of assumptions are necessary for credibility problems to arise in a rational expectations world:

First, monetary and fiscal authorities cherish objectives that are not shared by either the median voter or the forces that determine market outcomes. Even after governments have committed to a stability pact or any other disciplining device, they do so not because of a change in preferences but because they seek a better result, given the constraint of private sector behaviour. The median voter or financial markets are able to punish the authorities for their temptation to deviate from the preferred outcome of the private sector. The trigger mechanisms for deterrence are inflationary expectations for monetary policy and default ratings for fiscal policy, respectively.

Secondly, economic distortions arise because governments engineer them. The economy itself generates temporary disturbances or nominal rigidities at most, distortions of a sort that cannot possibly lead to *continually rising* inflation or debt but only to high levels of either. Inflation occurs because the authorities “inflate” the economy and not because they overaccommodate inflationary pressures arising in the economy. Perennial budget deficits occur because governments go on unwarranted spending sprees and not because automatic stabilisers work as they are supposed to in a recession while public debt is off the steady state.

This stylized picture of economic policy rests on two specific, ‘new classical’ assumptions: a) the authorities strive for super-natural employment levels, i.e. they typically distort market equilibria instead of reacting to

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because real world actors, say unions and employer associations or progressive and conservative administrations, may have different models about the working of the economy and the effectiveness of policies in mind. In other words, it is not rationality *per se* but *common* private sector knowledge that seems to be the problematic assumption (Laidler 1988: 702).

disequilibria like recessions or shocks; and b) authorities are fully in control of economic variables like the inflation rate or budget deficits.<sup>12</sup> These assumptions amount to a rather distorted picture of macroeconomic policy making in EMU and its member states.

1. Above all, employment in most EMU member states is below the 'natural' level (McMorrow and Roeger 2000: 18-20). Thus, activist policies to reduce unemployment would not necessarily create disequilibria in economies that were in equilibrium before the intervention.
2. Even critics of the ECB may concede that her policy is made difficult by the fact that transmission of monetary signals is highly uncertain. Recent research suggests that there is no stable relationship between interest rates, growth of the monetary base and price level changes, neither in the US nor in EMU (Angeloni et al. 2002, Bean et al. 2002).
3. Moreover, the role of stabilising fiscal policies in EMU has yet to be established. Some argue that national automatic stabilisers are effective and sufficient (Artis and Buti 2000). Others have criticised the SGP for effectively mandating pro-cyclical fiscal policies as long as governments have not achieved a long-term balanced budget position (Goodhart and Smith 1993: 433; Obstfeld and Peri 1997: 246). It is therefore at least hard to believe that private sector agents hold anything like a common rational belief on what the impact of fiscal stimuli would be.
4. Last but not least, Drazen and Masson (1993) have shown the theoretical possibility that toughness, i.e. sticking to the rules in the presence of adverse shocks, may undermine the credibility of time-consistent policies in the future. A sufficient condition for a negative-

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<sup>12</sup> "To the extent that monetary policymakers find the natural level of employment too low, they may be tempted to create monetary surprises in order to push employment above its natural level even at the cost of some inflation." (Cukierman 1992: 27)

sum game of tying one's hand is some persistence in economic phenomena like unemployment.<sup>13</sup>

In sum, it seems to me that neither are EMU policymakers fully in control nor can their policies generally be accused of striving for disequilibria. If EMU is a potentially legitimate and sound undertaking, it must be built on the assumption that policymakers have changed their preferences and intend to make stabilisation policies more effective. This is not just wishful thinking. The example of Germany, both a rich and stability-oriented country, as well as the promise of low interest rates, given high public debt levels, were two good reasons for EU governments to seek a macroeconomic policy regime such as EMU.

Despite this criticism, one has to concede that the disciplining view has alerted both policymakers and academics to political economy issues that need to be taken seriously by any proposal for policy coordination. These were pertinent for the design of entry rules to EMU but, as the experience so far indicates, seem to be rather less helpful as working rules once EMU has been established.

#### ***4 Policy coordination as an insurance arrangement***

The insurance view implicitly challenges all of the above assumptions. It tries to provide a theoretically more appealing basis for the traditional welfare economic approach. Traditionally, policy coordination has been seen as a welfare improving measure to deal with policy spillovers when economies are interdependent, i.e. when they are not small countries for each other. Policy coordination can amend this second best situation by governments optimising a common objective function which internalises this externality (Hamada 1985). Yet, these welfare economic gains have

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<sup>13</sup> "Policies that raise unemployment into the future, for example, will lower the 'threshold' level of the random shock at which a future policymaker will find it optimal to devalue." (Drazen and Masson 1993: 25) If one substitutes 'to devalue' by 'to break the rules of the SGP' and takes into account that persistence of unemployment is clearly a relevant trait of continental European labour markets, the model suggests that the operation of the SGP may become an ever bigger problem for EMU.



repeatedly been found to be too small for countries to engage in serious policy coordination. After all, already modest gains from providing the public good of common policy optimisation are further diminished by enforcement costs to contain free riding, endemic in any provision of a public good.<sup>14</sup>

Despite its flawless welfare economic reasoning, this considerable body of literature has rarely been consulted to inform EMU institution building and is only now re-discovered (Mooslechner and Schuerz 1999). My interpretation of this literature in terms of an insurance view is an attempt to show that it is in fact more relevant to the concerns of EMU than the theory of optimum currency areas (Schelkle 2001a). First of all, it would take into account the uncertainties of policy making in an environment that policy makers have deliberately chosen to change. Moreover, I suggest that the cost-benefit assessment may turn out to be more favorable if policy coordination is evaluated as an insurance arrangement. Lastly, I will argue that the integration of financial markets in EMU, while inevitably internalising spillovers of policy making, is not a perfect private sector alternative to the insurance that policy coordination could provide.

#### **4.1 Policy coordination under uncertainty**

Uncertainty is fundamental if policy coordination is thought to operate as an insurance arrangement. A first step therefore is to show that policy coordination in EMU is essentially dealing with specific forms of uncertainty.<sup>15</sup>

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<sup>14</sup> See, however, Canzoneri, Cumby and Diba (2002) for a critical review of this finding. The gains found in the literature are so small because of strong assumptions as regards the functioning of markets or the symmetry of shocks.

<sup>15</sup> Gosh and Masson (1994) is a superb textbook treatment of policy coordination under uncertainty, De Grauwe (2000) a more recent application to EMU. ECB (2001) outlines monetary policymaking under uncertainty to justify its two-pillar strategy of targeting inflation and a monetary aggregate.

- a) Uncertainty may stem from the incidence of exogenous shocks or less than fully synchronised business cycles in member states. This type of uncertainty is central to the textbook treatment of monetary integration, i.e. the theory of optimum currency areas (Mundell 1961).
- b) But EMU policy making is also concerned with uncertainty that is of an *endogenous* nature, i.e. a consequence of integration itself. In particular, the transmission and therefore the aggregate impact of monetary policy is highly uncertain since regions may react very differently to interest rate hikes.<sup>16</sup>
- c) Another endogenous source of uncertainty is less immediate and inherently of a long-term nature. EMU will induce fundamental changes in member states' economic structures. Wage bargaining systems and fiscal regimes are adjusting to the new monetary environment which in turn affects the transmission of monetary policy.<sup>17</sup> Yet the course and the extent of these interdependent changes are fraught with uncertainty.

In a situation of profound uncertainty, risk-averse authorities would want to coordinate their policies with others not only to achieve the warranted *level* of an objective but also the warranted degree of its *volatility*. To achieve an optimal degree of both, policymakers have to dispose of two instruments for each objective. In the absence of coordination, they do not fully offset shocks to an objective since a more active use of policies increases volatility. Thus uncoordinated action will be overly contractionary or expansionary, depending on the qualitative influence of the multipliers. This suboptimal stance of uncoordinated policies is transmitted to other countries. Policy coordination can then be thought of providing an additional instrument which allows to achieve a superior

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<sup>16</sup> This has been shown for the US (Carlino and DeFina 1997).

<sup>17</sup> For first evidence on this see Soskice and Hancké (2002).

combination of target level and volatility, both for the individual country and for the integrated area.<sup>18</sup>

## 4.2 Policy coordination as insurance

Governments will engage in policy coordination under uncertainty if it is seen as a mutually advantageous insurance arrangement, analogous to immunisation. The pooling of risks between interdependent economies insures each single country. E.g. if the respective country experiences a (more severe) recession, coordinated (more) expansionary policies of others serve to prop up export demand for the country in difficulties.

Simultaneously, this is potentially advantageous for those others since their coordinated action may dampen the decline of export demand they face from the country in a downturn.

How could EMU policy coordination insure against the risks that emanate from the uncertainties of policy making outlined above? To illustrate, I sketch the insurance that *discretionary, event-driven* policy coordination can provide. The advantages of rule-based coordination will be discussed in section 6.

- a) The first of these uncertainties provides the conventional case for insurance. Since a single country cannot insure against a national business cycle or an asymmetric shock that hits the national economy, policy coordination is a way to pool the risks of national income fluctuations at a higher level of aggregation. For instance, governments could agree *ex ante* that each country's contribution to the aggregate stance of fiscal policy should be determined with a view on each country's stage in the business cycle.<sup>19</sup> That itself must be assessed by

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<sup>18</sup> The basic analytics are outlined in Schelkle (2001a), based on Gosh and Masson (1994).

<sup>19</sup> Casella (1999) is an ingenious theoretical proposal for combining the concerns about fiscal consolidation in EMU with the need for counter-cyclical stabilisation. She suggests to endow member states with tradable deficit permits which would allow to choose an aggregate target for the Union so as to get the right policy mix, and then allow to trade these permits so as to get the appropriate counter-cyclical stance for each member.

using a hard to manipulate indicator, like the percentage deviation from a country's unemployment trend (Italianer and Pisany-Ferri 1994). A country that experiences a higher than EMU average increase in the national unemployment rate would have to contribute less to fiscal restraint (cut spending less severely) if fiscal restraint is required in the aggregate to achieve the appropriate policy mix.

- b) The second source of uncertainty which is directly endogenous to monetary integration, i.e. originating in a common interest rate policy, can be similarly insured against. For instance, in regions with a concentration of manufacturing, firms are more highly leveraged and depend to a higher degree on long-term credit (Carlino and De Fina 1997). An interest rate rise will then dampen economic activity more severely than in a region dominated by services. Again, the EMU members' fiscal response to the ECB's move could be planned on the basis that countries with a concentration of employment in manufacture will have to contribute less to tightening of the fiscal stance. And the other way round in an expansionary adjustment of the policy mix: the authorities of countries with a high share of manufacturing would have to stimulate aggregate demand more than other member states.
- c) The third type of uncertainty, generated by long-term structural changes and thus indirectly endogenous to monetary integration, is difficult to insure specifically. This is because the risk cannot be ascribed to causes that are exogenous to what the insured do: the risks are associated with government reforms or changing strategies of wage bargaining parties that are to some extent a response to monetary integration. More generally, the insurance of this risk is haunted by the notorious moral hazard problem. To some extent, it would be insured along with the other two, but only partly and somewhat incidentally. I will come back to this after the political economy of EMU policy coordination has been discussed.

Why could the cost-benefit ratio for policy coordination be more favourable, at least theoretically, if seen as an insurance arrangement? Policy coordination may be more beneficial than appears at first sight because it dampens not only the fluctuations that actually occur but, more importantly, affects the probabilistic distribution of national incomes. Aggregate EMU income is the possibility set of single members' income distributions. When governments devise their fiscal policies, they take this possibility set as given. However, while the set, i.e. the distribution of EMU aggregate income, is given for the member state, member states' behavior may jeopardize the very fact of it being given. Policies that are only concerned with national fiscal consolidation or domestic employment create negative externalities which show up as an imminent threat to stability for the currency area as a whole. Policy coordination can internalise these externalities of nationally devised policies and thus maintain or even improve the possibility set of national income distributions. Improvement of the possibility set results if either the expected value of national income rises for given volatility or volatility of income becomes less for a given mean value. Less stabilisation is then required to begin with and the effectiveness of coordinated action in actual stabilisation is only part of the benefit it generates.<sup>20</sup>

### **4.3 The private insurance alternative to policy coordination**

It could be argued that policy coordination is redundant in providing insurance precisely because monetary integration has taken place. Now that an EMU-wide integrated capital market has been created, financial markets could provide private sector insurance for single member states (Atkeson and Bayoumi 1993; Chari and Henry 2002). Insurance may

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<sup>20</sup> The argument is analogous to recent findings of Fatás and Mihov (2001) as regards automatic stabilisers. They provide strong evidence from international as well as intranational data that automatic stabilisers not only dampen fluctuations of demand over the business cycle but that they also dampen the underlying volatility of output. In other words, automatic stabilisers change the characteristics of the business cycle itself. This is what I propose as an effect of policy coordination seen as insurance.

result from the ownership of assets as well as from cross-border borrowing. The ownership of assets in other countries makes personal income less sensitive to variations in domestic national income. And if it is possible to borrow from other countries, then a decline in national income can be offset by financing expenditures from foreign credit. EMU has eliminated the currency risks of doing so. It has indeed been shown for the US that the role of private capital markets is crucial in cushioning region-specific shocks (Atkeson and Bayoumi 1993; Athanasoulis and van Wincoop 1998).<sup>21</sup>

The integration of EMU financial markets undeniably goes some way in providing private insurance to personal income. Yet, from a public policy point of view, it matters that there is a distributional bias in the private insurance to personal income that financial markets provide. It accrues only to households and firms with interregionally – in the case of EMU: internationally - diversified portfolios of assets and liabilities. Low-income and wage-dependent households are much less insured that way because they make a living on current earnings and current transfers like public pensions rather than on income that flows from holding assets. Thus, even if life insurers or private pension funds become more internationally diversified in EMU, this leads to a diversification of personal wealth only for those households who own such assets. Atkeson and Bayoumi (1993: 316) estimate that even in the US, a rather lean welfare state, the bulk of insurance against labour income fluctuations is provided by the federal tax and transfer system.

Moreover, financial markets are less likely to provide equally effective insurance to governments as they do to private sector agents. EMU member states' demand for insurance in financial markets, i.e. borrowing

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<sup>21</sup> Asdrubali et al (1996) find that 39% of shocks are offset by cross-regional ownership claims to output and 23% by the extension of credit on an interregional basis, while only 13% of shocks are offset by the federal government. Using a corrected specification and estimation procedure, Mélitz and Zumer (1999) have a similar estimate of 13% for the effect of federal stabilisation but the role of financial assets and credit are equally important, each offsetting 24% of the shock.

for the sake of national income stabilisation, suffers from problems that are similar to those of individuals seeking unemployment insurance from the private sector (cf. Barr 2001: ch.3):

- In a currency union, probabilities of risks to national income and employment are highly interdependent. Interest rate changes are the same for all, even if economic activity is more responsive in some regions than in others. To the extent that business cycles result from monetary and trade relationships, they will become more synchronised among EMU member states. Thus, the risk premia for government borrowing would change procyclically, namely rising in a recession and decreasing in a boom. This is obviously contrary to what compensating stabilisation would try to achieve. Even if it cannot change the co-movement of risk premia, policy coordination may dampen these procyclical interest rate or risk premia fluctuations as long as they are imperfectly correlated.
- Information problems in sovereign credit relationships abound. Lenders do not know whether and how the present administration will change its policies after the credit contract was signed. Yet lenders do know – and sovereign borrowers have no means to prove the contrary – that governments can declare a moratorium without being subject to the same legal sanctions as individual borrowers. Nor can lenders easily assess whether the present government is a high or low risk borrower: will it be able and willing to implement policies that are consistent with repayment and orderly debt service? This does not only depend on the present government's intention, but also on private sector responses and the policies of future administrations (Drazen and Masson 1993: 2). Therefore, present administrations are often assessed on the basis of a country group rating. After forming EMU, the monetary union as a whole may be subject to group rating. This is the inefficiency that the SGP is supposed to deal with. The policy coordination it provides wants to prevent that all members are punished for the profligate fiscal policies of one or a few member states.

Thus, one need not deny that currency unification and therefore financial market integration play a role in smoothing regional or national income fluctuations. This is mainly because currency unification has eliminated bilateral exchange rate volatility and the risks of balance of payments crises for individual member states. But cases may still arise in which government borrowing in an EMU-wide capital market is not a perfect substitute for coordinated action.

### ***5 The political economy of burden-sharing in policy coordination***

The political economy of policy coordination deals with two issues. First, policy coordination involves burden-sharing, i.e. redistributing costs and benefits of adjustment.<sup>22</sup> The two approaches to policy coordination outlined above suggest distinct forms of burden-sharing between participating governments. A disciplining device deliberately imposes regressive burden-sharing because this represents the political cost necessary to tie governments' hands. An insurance arrangement, in contrast, requires actuarially fair burden-sharing because only then governments will sign a voluntary insurance contract, just like any other economic actor who seeks insurance.

Second, policy coordination is not only about cooperation between governments, it is a two-level game (Putnam 1988). Originally, the notion of a two-level game pointed out that international agreements depend for their effective implementation on consent and cooperation at the domestic level. But the game may also be played in reverse and international agreements instrumentalised to fend off domestic opposition to the government's agenda. The burden-sharing patterns of international policy coordination can be explained in this instrumental sense. I discuss, first, what either view's underlying perception of a collective action problem in

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<sup>22</sup> There is a growing political science literature on burden-sharing, in particular with respect to EU immigration and refugee policies. The seminal paper is Olson and Zeckhauser (1966).



policy making is. The opposite forms of burden-sharing can then be shown, secondly, to provide remedies to this problem as either one perceives it.<sup>23</sup>

### 5.1 The logic of collective action problem in policy making

The logic of collective action extends the identification of free riding problems that haunt the market provision of public goods to the realm of government provision (Olson 1982: ch.2). From the point of view of beneficiaries, these public goods can be “true goods” like a clean environment or “collective bads” like trade protection, but also macroeconomic phenomena like high employment and price stability. Individuals have reason to abstain from contributing to the provision of a public good because, by definition, no one can and must be excluded from its use. Therefore private suppliers may not provide it at all or in inefficient quantities. Government may step in. Yet the question resurfaces: who cares to articulate political demand for a public good, who makes the effort to bring it to the attention of the potential supplier, i.e. government? The logic of collective action contends that smaller groups with narrowly defined interests are more likely to overcome the free riding barrier since they lobby for public goods which visibly benefit their members. The outcome is a kind of government failure: the provision of a public good becomes more likely the fewer beneficiaries there are.<sup>24</sup> The perception of the logic of collective action problem is intimately related to how one conceptualises policy making.

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<sup>23</sup> An insurance contract is ‘actuarially fair’ if expected benefits (present value of contingent payments) are ex ante equal to the expected costs (present value of contributions) of the contract.

<sup>24</sup> Formally, this theoretical paradox results from the interplay of economic and political forces: Production and consumption of a public good is economically efficient if the *sum* of marginal benefits equals its marginal costs while political lobbying is fiercer for public goods that benefit only a few (Olson 1982: ch.2). A notorious example for this paradox is agricultural protection in the EU where narrow farmer and related industry interests dominate wider consumer interests.

- Special interests may directly shape the *preferences of the authorities* if policy making is a purely opportunistic undertaking in which politicians are entrepreneurs who ‘sell’ policies against votes.
- Alternatively, special interests can be seen as imposing a *constraint on government policies* if policy making is driven by its own intentions, yet depends on consent from diverse interests for its implementation.

The disciplining view must assume that special interests have an immediate influence on the preferences of the authorities. Otherwise it would be hard to explain where the discrepancy between the objective functions of government and ‘the private sector’ comes from. ‘The private sector’ is represented by the median voter. But the private sector must also be made up of special interest groups. If not, why would democratically elected governments seek levels of employment that are ‘super-natural’, i.e. higher than what market forces would gravitate to? Similarly, the logic of collective action must be assumed operating in these models in order to explain why governments try to exploit a tradeoff like the short-run Phillips curve that the same models show not to be exploitable in any sustainable sense. The gap has to be filled with the role of special interest influence on the preferences of policy makers for the new classical story to be at least consistent, if still not entirely plausible.<sup>25</sup> The resulting credibility problem is thus a variant of moral hazard. The government was elected into office by the median voter but after taking office it engages in policies driven by special interests. In the economic models used, these special interests are typically those of trade unions that are responsible for the inflation bias of government policy. Governments thus cause disturbances in an economy that would otherwise tend to an equilibrium in which all unemployment is voluntary or frictional. The pervasive ‘inflation surprises’ in the political economies of

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<sup>25</sup> This contrived exploitation of a short-run tradeoff implausibly assumes the elusive effect of doing so to last at least as long as the electoral cycle. Otherwise, rational policy makers would not be tempted to exploit it since the evaporation of the effect would diminish their chances for re-election.

the disciplining view suggest that there is no economically relevant uncertainty independent of government action.

For the insurance view, in contrast, it seems more consistent to see special interests as a constraint on policy making. In representative democracies, authorities react to disturbances and accomodate diverse demands from the private sector for intervention. Policy making depends on heterogeneous private interests for its effective implementation.

Conceptually, this is another expression of transmission uncertainty of type b) or c) outlined above. The intentions of the authorities in responding may or may not be those of the median voter, given that they are ideologically driven or based on subjective notions of the 'common good'. Yet they must compromise on their original intentions as much as the median voter who is unlikely to find his or her ideal party.<sup>26</sup> It is therefore the uncertain outcome of political contests how much impact policy measures have on the respective objectives.

The logic of collective action represents a particular variant of this uncertainty. It creates an adverse selection problem for policy making: narrow interests are more likely to raise their voice and put pressure on the authorities. These pressures can push the policy stance to be more accomodating than originally intended.<sup>27</sup> The active exploitation of the short-run Phillips tradeoff by a government is thus largely apparent. In a boom, the fiscal and monetary authorities may give in to business and union interests and accomodate the inflationary pressures for too long. Or, in a recession, they give in to rentiers' interests and forego opportunities

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<sup>26</sup> The more general theoretical point here is that the prevasive application of the Hotelling theorem of two-party competition, deriving a convergence of political programmes on median voter preferences, assumes too much homogeneity of the 'demand' (voters) and the 'supply' (parties) side. For the very same reason, median voter models seem to me inappropriate to discuss the two-level games of policy coordination between mature democracies.

<sup>27</sup> This also seems to be the underlying assumption of commitment devices in Bronk (2002). Yet all models that propose an advantage of 'tying one's hands' assume that the government's preferences are the problem and not its constraints. Cf. Cukierman (1992: ch.1).

to stimulate the economy out of stagnation. Such potentially inadequate accomodation is different from actively trading off price stability for employment and vice versa. The activist interpretation must assume that policy makers constantly overestimate their steering capacity despite their making repeatedly the experience that the steering capacity is limited given the inherently uncertain world of political contests. In contrast, accomodation results from uncertainty in the transmission of policy that exists independently of government action. In turn, government action may add to the volatility of the economy even if it is only a response to private sector demand for intervention.

## **5.2 Managing the logic of collective action in the disciplining view**

If moral hazard is of the variant that the disciplining view contends, burden-sharing in policy coordination must be used to prevent or sanction such behaviour.<sup>28</sup> This can either be done by supervision, i.e. those who share the adjustment burden of one country may want to check whether the burden could have been less or even nil if prudent policies had been pursued. Or incentive mechanisms deal with the problem, e.g. by stipulating co-payments in the case of damage. In the present context, this would mean that governments explicitly limit the extent of burden-sharing. For instance, countries may commit to adjust their policies to the needs of those in a downturn only after this downturn has passed a certain threshold. It is important to note that these devices all suppose that the preferences which give rise to moral hazard cannot be changed. They only make it more costly to engage in the opportunistic behaviour that results from such preferences.

Does the SGP, which has been characterised as a disciplining device in section 2, contain provisions that prevent or sanction moral hazard? Supervision and incentives are provided by the Excessive Deficit

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<sup>28</sup> Cf. Barr (2001: 21-23) for a concise outline of the theory of moral hazard and its solutions in private insurance, Kreps (1990: ch.16) for an extensive textbook treatment.

Procedure which lays down the rules for constant monitoring of each member country's fiscal policy. Budget deficits that reach the 3%-limit are interpreted as indicators of imminent moral hazard which trigger successive steps of warning and sanctioning. However, even if Ecofin in its role as a supervisor would find that a country exceeds the deficit limit due to a severe recession that is not of its own making, the best that a country could get is no formal censure. That is, the absence of sanction but not assistance is what member states receive in a downturn. Similarly, the incentive mechanism of the SGP that is meant to prevent moral hazard imposes a supplementary payment, not simply a co-payment, on a country the public finances of which are already in dire straits. The redistributive arrangement stipulates that the agent bears a burden in addition to the one that is caused by the damage of recession.

The SGP implies regressive burden-sharing in that those which can least afford it bear the costs involved, both of their own downturn and of demonstrating the prudence of macroeconomic policies in EMU as a whole. It is this latter feature which makes the SGP regressive, namely that governments in trouble have to protect the public good of monetary stability. Seen as a disciplining or commitment device, this kind of burden-sharing is a cost that governments voluntarily impose on themselves in order to gain credibility for non-inflationary policies. All this is necessary to constrain governments which unfettered would betray the trust that was bestowed upon them by the median voter.

Seen from the perspective of the insurance view, this amounts to perverse redistribution both ex ante and ex post.<sup>29</sup> Not only is the implementation of such a disciplining device based on problematic theoretical assumptions

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<sup>29</sup> To draw the analogy to a health insurance contract: the SGP's incentive mechanism is similar to a promise by the buyer of a policy to pay an additional premium in case he or she becomes sick. This is to ensure the company selling the contract that the buyer will not abuse the protection. The insurance company on its part promises to do without the payment of this excess premium only if the patient has to undergo life-saving treatment in the emergency room. But even in this case the insurer would not promise to pay out benefits!

about the abilities and intentions of policy makers. Practically more relevant is that regressive burden-sharing is potentially divisive for EMU, both economically and politically:

- Governments tie their hands not only *to* stability-oriented policies, they also tie it as regards *the use of* stabilising policies. Credibility is gained at the expense of policy flexibility in general and at the expense of the capacity to counter-cyclical stabilisation in particular.
- In cases where regressive burden-sharing is not only a preventive measure but actually exercised, it is likely to steer political resentment in the country affected. The electorate is unlikely to approve of seeing the country exposed to an externally imposed hardship on top of a large budget deficit and rising domestic unemployment.

This is why I think that sustainable European integration calls for another approach to policy coordination.

### **5.3 Managing the logic of collective action in the insurance view**

While moral hazard can never be excluded in an insurance arrangement, preventing adverse selection is key if EMU is politically legitimate and economically sound. Burden-sharing must then be used to safeguard against risks that are induced by the availability of insurance itself.<sup>30</sup> The induced risk here is that predominantly those governments seek policy coordination which easily fell prey to special interest group pressures in the past. This is likely to paralyze effective coordination or to give it a destabilising bias.

One solution is to separate the exogenous from the induced risks. The way forward is to devise incentive mechanisms which induce the countries to reveal their risk quality. An example of this is to ask prospective members to undertake structural reforms even before entry, like delegating of monetary policy competencies, that are essential for future policy

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<sup>30</sup> Barr (2001: 20-21) provides a concise outline of the theory of adverse selection and Kreps (1990: ch.17) an extensive textbook treatment.

coordination. If they succeed in implementing these reforms against opposition from domestic lobbies, they must be considered good risks and are allowed to participate. Note that this mechanism requires countries to have revealed preferences that are in line with what is required for stability-oriented policy coordination.

Another, the social insurance solution, is compulsory membership. This is to pool the good and the bad risks rather than allow for self-selection which financial markets could perceive as a pool of bad risks. Fortunately, integration itself is a variant of this solution. By shifting the locus of macroeconomic decisionmaking, governments can hope to divert these special interest groups so that policy making becomes inherently less accomodating (Bofinger 1995: 8-10). The pooling of risks requires to give only those governments a say in policy coordination that share the burden with other countries. Variable geometry and other flexible integration concepts are incompatible with this solution, at least as regards policies that are considered important for macroeconomic stabilisation.<sup>31</sup> The pooling of risks assumes that governments with heterogenous preferences seek monetary integration, their common interest in policy coordination being to get more room for manoeuvre in the domestic arena.

The two solutions of the adverse selection problem taken together, namely seperating and pooling of risks, seem contradictory. Yet, in this context they may be seen as loosely complementary. The stipulation of preconditions, meant to reveal the risk quality, should be devised so as to ensure the basic mechanisms for future policy coordination to be in place. Integration then provides the insurance against the uncertainties from adverse selection and other sources, insurance that the former bad risks particularly need. The promise to reap the benefits of membership in the

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<sup>31</sup> From that point of view, Germany's recent escape from censure indicated another deficiency of the SGP. The German government was spared the blame partly because the UK government was supportive, arguably more out of concern for its domestic situation than for EMU. In other words, the SGP rules were suspended with the help of a country that is not even a member of EMU. – For the different concepts of flexible integration see Wallace and Wallace (1995).

revealed good risks' club will presumably assist them to mend their ways. The latter is a supportive economic argument for exercising political – in contrast to legalistic - judgement in assessments of whether entry criteria have been met.

Table 1: Comparison of the two views of policy coordination

	<b>Disciplining view</b>	<b>Insurance view</b>
<b>Policy making</b>	Causes disturbances; preferences lead to inflation bias.	Responds to disturbances; driven by political agenda.
<b>Private sector representation</b>	Representative household, median voter.	Different economic strata, heterogeneous groups.
<b>Logic of collective action</b>	Shapes preferences of government; creates moral hazard problem of policy making.	Constrains the implementation of government policy; creates adverse selection problem of policy making.
<b>Policy coordination as a general solution</b>	Threat of regressive burden-sharing to tie government's hands.	Promise of actuarially fair burden-sharing to enable more effective stabilisation.
<b>EMU as a particular solution</b>	Surveillance (Excessive Deficit Procedure) and incentive mechanism (fine).	Incentive mechanism (structural reforms as entry rules) and risk pooling (ECB, community stabilisation).

In policy coordination that is insurance, burden-sharing must be actuarially fair ex post redistribution from the well-performing members to those in a downturn. It is redistribution in the sense that countries in a downturn have to contribute less than proportionally to the collective stabilisation and adjustment effort or get some assistance in their individual struggle. Yet this very solution to the adverse selection problem of policymaking may come at a cost. It may have moral hazard in its wake.<sup>32</sup> After the

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<sup>32</sup> Rogoff (1985) has argued that the domestic wage bargain may become more inflationary due to policy coordination between governments. His model necessarily shares the problematic assumptions of the disciplining view (sect. C; Schelkle 2001b: 134-136).



coordination framework has been established, special interest groups could get easier access to government because it does not bear the full cost of overly accommodative policies. Preventing such moral hazard must not destroy the insurance features of policy coordination, however. The solution calls not for regressive burden-sharing but for limited, only partial burden-sharing which is the private insurance equivalent of co-payments.

Table 1 sums up the differences between these two approaches to the political economy of EMU.

### ***6 Commission proposals in light of the insurance view***

The most urgent reforms suggested by the insurance approach need not be invented from scratch. The following sections show that old and new Commission proposals, if fully implemented, would have made EMU policy coordination more of an insurance arrangement. This means that the various proposals do have a coherent theoretical underpinning which may not always have been obvious to observers or even policymakers themselves. I will first discuss in what way the Maastricht framework contains elements of an insurance arrangement, albeit only partially. Then I review Commission proposals that responded to the German government's draft of a stability pact in the mid-1990s. Finally, an even earlier proposal for a community stabilisation mechanism will be outlined to show that EMU policy coordination could provide as much stabilisation as the federal budget in the U.S. but at a much lower fiscal cost.

#### **6.1 Entry criteria to prevent adverse selection**

The ECB can already be seen as an element of EMU policy coordination as insurance. The common central bank represents an institutionalised pooling of good and formerly bad risks. The latter had to mend their ways as regards the conduct of macroeconomic policy because they had to be ready to accept an independent monetary authority. More precisely, the Maastricht criterion of central bank independence can be interpreted as

an incentive mechanism. It required to fulfil a precondition for later policy coordination.

In contrast, the performance criteria of the Maastricht Treaty make little sense in this respect. Meeting them does not contribute to institutional prerequisites for sustainable policy coordination. Nor do the performance criteria separate between the bad and the unlucky good risks which miss the criteria, or between the good and the lucky bad risks which fulfil them. Their underlying assumption is that of the disciplining view, namely that governments are in control and therefore to be held fully responsible for the observable outcomes, be it the fiscal situation, inflation or the longterm interest rate. The SGP basically made one entry rule for EMU participation to be the working rule for fiscal policy coordination and thus retained the focus on the fiscal behaviour of each single member state. The insurance view, in contrast, calls for genuine working rules with a view to EMU as a whole.<sup>33</sup>

## **6.2 Quasi-automatism as potential assessment of the insurance case**

One of most controversial issues in the German treasury draft for a stability pact was its suggestion of a purely automatic excessive deficit procedure. It proposed that rules only, not Ecofin decisions, would set in motion the excessive deficit procedure. I.e. whenever a defined threshold has been passed, warnings and sanctions would be issued irrespective of the reasons for this happening.<sup>34</sup> This makes obviously sense in a disciplining view of fiscal policy coordination. For in this view the first two tests of the policy framework discussed in section 2 revealed a lack of automatism that allowed for deliberations in the Ecofin Council and

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<sup>33</sup> I am grateful to Francisco Torres (Catholic University of Lisbon) who suggested to see necessary reforms of the EMU policy framework as attempts at establishing working rules in contrast to entry rules.

<sup>34</sup> Cf. Stark (2001) and Costello (2001) for insider accounts of the debate surrounding the drafting of the SGP, from a then German treasury official and from a member of the Commission, respectively.

behind the scene interventions of governments, unsuccessful in the Irish case, successful in the German and Portuguese cases.

In its response to the German draft, the Commission vehemently opposed pure automatism and called for a sequencing of the procedure that would allow each step to be subjected to political decision. Evidently, the Commission succeeded in this respect. But in light of the German escape from censure, one cannot help but see a sad irony here. It was widely perceived as a defeat of the Commission. Thus, the country that under a different administration had insisted on rigid automatism was the one that exploited the opportunity for political discretion, driving Ecofin to turn down the Commission's recommendation.

How can we explain the Commission's opposition to pure automatism, presumably even after the apparent 'defeat' in the encounter with Germany? From an insurance point of view, the information asymmetry inherent in insurance contracts provides a rationale for some political discretion. Political discretion concedes that if an insurance case is about to arise, i.e. an early warning has to be issued, it has to be assessed in each instance: is it due to bad luck (legitimate insurance), or because of opportunistic behaviour of the insured (moral hazard) or hidden risks that call for a more fundamental review of the contract (adverse selection)? The prerogative of Ecofin allows for such a study of the individual case. It is itself rule-based, i.e. Ecofin cannot abstain from a decision if the Commission duly recommends an early warning. The state-contingent rules that Pisani-Ferry (2002: 12) proposes as a kind of third way between discretion and automatism seem to have the same goal.

The role of Ecofin is then potentially that of an insurer that has the right to step in and prevent the insurance case from actually arising, e.g. ask the German federal government to strike a deal with regional governments to rein in the national public deficit. From the point of view of the insured governments, the political prerogative can be interpreted as a commitment to 'inverse moral hazard', namely to promise behavioural

change if necessary to avoid the insurance case to arise.<sup>35</sup> Moreover, in controversial cases the prerogative of Ecofin acts as a kind of ‘Sollbruchstelle’ (Lohmann 2000). It is the Council that has to take the blame when the rules of the SGP are stretched to the limits, e.g. a powerful member state asking for being treated as if above the SGP, it is not the Commission who can thus protect its role as an honest broker and preserve its precarious legitimacy.<sup>36</sup>

Thus, the element of political discretion, a concession to rigorous discipline in the disciplining view, can be seen as providing for flexibility in a profoundly uncertain world of policymaking (Lohmann 2000: 393-397). This holds notwithstanding the fundamental problem with the present arrangement which is, of course, that it does not give any insurance when the insurance case actually and legitimately arises. Another problem with the present arrangement that gives Ecofin the right to override the rules is that it may create moral hazard. The Commission’s recent proposal to apply the Community method to policy coordination can be seen as addressing this problem.

### **6.3 The Community method as an approach to risk pooling**

Closely related to the fundamental lack of insurance is the other deficiency of the present policy framework, namely that it does not target the aggregate EMU budget deficit. In its response to the German draft in the mid-1990s, the Commission proposed to take the aggregate into account when assessing the appropriate stance of the national fiscal policies (Costello 2001: 116-117). In this respect, the Commission did not succeed, the Council rejected it. Again, this makes sense if fiscal discipline of each single member state is the overriding concern since pooling the risks and targeting the aggregate may require to compromise on an

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<sup>35</sup> I am grateful to Nicholas Barr (LSE) for the idea that self-imposed conditionality may be interpreted as “inverse moral hazard” on part of the insured.

<sup>36</sup> For this ‘second order legitimacy’ of EU institutions see Scharpf (1999: ch.2).

individual country's discipline. The Irish government's plan to cut taxes when the larger EMU economies were in recession is a case in point. If in such a situation stabilising EMU as a whole had been the priority, Ecofin would have abstained from censuring what was admittedly a pro-cyclical fiscal policy of an individual country.<sup>37</sup>

This lack of a mechanism to target the aggregate stance and thus the policy mix is partly due to the intergovernmentalist set-up of EMU policy coordination as it stands. To amend that, the Commission has recently made a new attempt and suggested to apply the Community method to policy coordination. This would imply to give the Commission – or an independent body - the right to introduce proposals to the Council on the Broad Economic Policy Guidelines or on actions against national governments which, at present, the Commission can merely recommend. Furthermore, the Council should be allowed to reject such proposals only by unanimity, not by qualified majority as now (European Commission 2002a). From an insurance point of view, this would of course be a sensible differentiation between principal (insurer) and agent (insured) in the insurance arrangement that EMU policy coordination potentially amounts to. As it stands, the insurer and the insured are only differentiated insofar the government under scrutiny must not decide on its own reprimand. But the voting of other members is likely to be influenced by the expectation that one needs the collaboration of the respective country in a similar situation. This creates moral hazard in a disciplining as well as in an insurance arrangement, to the detriment of stabilisation.

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<sup>37</sup> Soskice and Hancké (2002), in contrast, accept the focus on single countries when they justify Ecofin's decision on Ireland for protecting the ECB from having to rise interest rates otherwise. This seems to me implausible for the very reason that the authors mention, namely that the Irish economy is too small to trigger inflation in EMU, let alone in an EMU that is in recession.

## 6.4 An early proposal for community stabilisation

This section illustrates how fiscal policy coordination would look like if it were devised as an insurance arrangement mindful of the political economy of EMU fiscal policy coordination. For this to be the case, it has to

- provide for actuarially fair burden-sharing;
- deal somehow with the adverse selection problem of domestic policy making;
- address potential moral hazard problems endemic in any insurance arrangement.

The proposal for a community stabilisation mechanism was devised on behalf of the Commission by Italianer and Verheukelen (1993) and Italianer and Pisani-Ferry (1994). The overriding goals were feasibility in political economy terms and effectiveness in a macroeconomic sense. 'Feasibility' meant to take into account the fiscal prerogatives of the member states which preclude a transfer of competencies for major automatic stabilisers, like income taxes or unemployment benefits, to the EU level. 'Effectiveness' was interpreted to be at least a degree of stabilisation achieved in the US fiscal federation where this dampening of state income fluctuations is the result of largely automatic federal tax and transfer changes.<sup>38</sup> These two criteria required to think about a stabilisation mechanism, on top of the national budgets and specifically created for the community, which would nevertheless be as effective as the federal budget in the US with its well-established array of automatic stabilisers.

The basic idea is simple. A member state will receive transfer payments if a negative shock causes its unemployment rate to increase more than the average of unemployment rates in the other member states (excluding the

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<sup>38</sup> Italianer and Pisani-Ferry (1994: 158-163) and Athanasoulis and van Wincoop (1998: 4-7) discuss various studies and come up with a consensual estimate of 15-20%. I.e., the federal budget in the US compensates almost 20 cents of each dollar that state incomes decline below their respective trends.

respective country from this latter average). The change in the unemployment rate is taken as an indicator that can be translated into income fluctuations via Okun's Law.<sup>39</sup> The amount of transfers would be proportional to the decline in income thus caused by the deviation of the country's unemployment trend from the others' average. The mechanism could be varied, in particular by paying transfers only if the deviation of the rise in unemployment passes a certain threshold, for instance by more than half a percent. The recipient of transfer payments would be the respective government, not persons who become unemployed. Italianer et al calculate the costs of such a mechanism (in different variants) to be slightly more than 0.2% of EU domestic product. This is considerably less than the costs of the US yardstick.

The reason for the Commission's federal stabilisation coming so cheap is partly the reason for it being an actuarially fair burden-sharing arrangement. It is geared to stabilisation only, i.e. to ex post redistribution in favour of countries hit by a negative shock. It abstains from redistribution *proper*, i.e. from transfers that are meant to deliver ex ante redistribution from rich to poor countries. The latter dominates fiscal federalism in established nation states where stabilisation tends to be a by-product of redistribution proper, for instance of progressive income taxation. The Commission proposal by contrast does not strive to make the income trends of the member states more convergent – this is the goal of cohesion policy and other structural funding – but to dampen the fluctuations around a given income trend. If negative shocks are truly random, participating governments rationally expect ex ante to pay as much into this stabilisation mechanism as they expect to get out of it. Yet, whether the insurance implied by this mechanism is actuarially fair also depends on how it is financed. There are basically three options:

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<sup>39</sup> Okun's Law proposes a stable negative relationship between the increase in unemployment and the growth of aggregate income

1. countercyclical contributions of member states, i.e. the transfers are paid by those that enjoy a stronger than average increase in their national income or employment, respectively;
2. payments out of a designated fund in the EU budget which would require to increase its size by about a fifth of its present volume;
3. payments out of separate fund that is not subject to EU budget rules like the requirement to balance the budget on an annual basis.

Only the first option is compatible with an actuarially fair insurance arrangement. A fund in or outside of the EU budget would be disproportionately financed by the richer member states and therefore be 'unfair' from an insurance point of view. However, given the different sizes of EMU economies, the pay-as-you-go financing of the first option would have to be bolstered by some additional funding to provide for cases in which Germany experiences an above average slowdown but only Greece a relative boom. The third option is preferable for this supplementary funding since it allows for countercyclical stabilisation.<sup>40</sup>

The first option also seems to be more effective in dealing with the adverse selection problem of policymaking. Especially in the case of poorer member states, it presupposes and calls for revealed commitment to the necessities of policy coordination. This is because the equitable burden-sharing according to the first option implies that a poor member state like Greece may end up paying transfers to rich Germany if the latter is hit by a negative shock. It also reveals the commitment of richer countries. Their governments may suspect, even if the design is actuarially fair, that they are likely to be net contributors for the very reason that in poorer countries the national automatic stabilisers, e.g. social insurance, are less developed and therefore employment more volatile.- The community stabilisation scheme is simultaneously a means to pool the good and the bad risks. Every country that participates in EMU would have to engage in this kind of rule-based fiscal policy coordination.

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<sup>40</sup> The proposal of Casella (1999) to issue tradable deficit permits would imply an alternative way of financing and implementing such a stabilisation mechanism.



The Commission proposal contains several precautions against moral hazard.

- First of all, the transfer is calculated as a percentage of the *deviation* by which a country's unemployment increases more than the average. That is, there is no compensation for a level of unemployment that is higher than average. This trigger mechanism for insurance payments ensures that the country has no incentive to pursue policies that lead to a permanently higher level of unemployment. On the contrary, it may be forced to pay for transfers to countries with a much lower level but an exceptionally high increase in unemployment while its own unemployment situation may be desperate but stable.
- Secondly and as already mentioned, the burden-sharing could be limited in that transfer payments set in only after the above-average rise in unemployment has passed a certain threshold. Such partial insurance reduces the incentive to engage in policies that make an increase in unemployment more likely because others share the costs of doing so.
- Lastly, governments receive transfer payments from the stabilisation mechanism, not the unemployed persons. This is another way of containing moral hazard, in this case of the individual worker to lessen his or her effort to find or retain a job.

Finally, it has been mentioned that the Italianer et al-proposals for fiscal policy coordination is of the rule-based type. This is to avoid some well-known drawbacks of discretionary policy coordination: Rules avoid the lags involved in ad hoc decisionmaking, e.g. due to different assessments of the need for action. Lags impair the very effectiveness of coordinated stabilisation, the intervention may even become procyclical.- In political economy terms, well-designed rules contain moral hazard and the effects of adverse selection while deliberation creates incentives to behave opportunistically in the hope to get away with it, either because the administration is not found out or because it avoids punishment through skilled negotiation.- Last but not least, from an insurance point of view,

rule-based coordination has the obvious advantage that it delivers more security. If governments are risk-averse, security is by definition the welfare gain they derive from insurance: one Euro of transfer payments that a government can count on thanks to the rules is more valuable than one Euro that is the uncertain outcome of a bargain.

## ***7 Conclusion***

Policy coordination, seen as an insurance arrangement, aims at enabling governments to use stabilising policies more effectively. Seen as a disciplining device, it aims at tying governments' hands to prevent the misuse of these policies. I have argued in this paper that the present EMU framework has been designed following the disciplining view. Comparing it to the insurance view reveals a paradox: Governments subject themselves to rules that *ex ante* impose additional burden on an economy already in trouble instead of promising to load it partly on to others. But they have to show such commitment only because they have illegitimate preferences to begin with. The insurance view, in contrast, is in principle compatible with EMU being a politically legitimate and economically sound undertaking.

The comparison also reveals that the difference between the two views as regards their underlying political economy assumptions can be traced to their opposing views about the impact of special interest groups on policy making. According to the logic of collective action, special interest groups have a disproportionate influence on the provision of public goods. The disciplining view sees the logic of collective action as directly shaping the preferences of government, their influence being ultimately responsible for a moral hazard or credibility problem of policy making. The insurance view, I argued in contrast, considers the logic of collective action as a constraint of government action, likely to cause an adverse selection problem of policy making in representative democracies.

In this perspective, past and recent Commission proposals provide for a coherent reform perspective. They can be seen as providing both the

collective security and the constructive discipline of an insurance arrangement. If implemented, these proposals would go a long way to make EMU policy coordination economically more stabilising and politically legitimate.

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