THE DIFFICULTIES OF FISCAL POLICY COORDINATION IN TIMES OF ECONOMIC AND FINANCIAL CRISIS

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Ever since the emergence of the democratic welfare state with its unprecedented borrowing capacities and incentives, fiscal policy making has been haunted by a deficit and debt bias. It is this underlying assumption about the nature of those in charge of fiscal policy, which make the coordination of fiscal policy in a common currency union desirably. First, in order for monetary policy to be efficient and second to avoid exactly the beggar-thy-neighbor policies, both in a fiscally frugal and proficient sense, witnessed in the eurozone for the past decade. Moving to 1997 these concerns informed the blueprint for EMU's fiscal rules, specifically the Stability and Growth Pact, short SGP.

The poor performance of the Pact to curtail deficits has been notorious. Given the past record the European Commission was weary when the economic and financial crisis erupted. How to achieve fiscal policy coordination during the worst recession since the 1930ies if this has not even been on national agendas during the comparatively sunny period first decade of EMU? Unsurprisingly as soon as the scope of the crisis emerged, calls were heard to suspend not only the SGP rules, but also Competition policy which is a further potentially potent tool of the Commission to constrain public spending. With the majority of member sates announcing considerable stimulus programmes ahead of any EU wide agreement, a EU level crisis action plan was agreed upon in December; the European Economic Recovery Plan, or short EERP. The plan essentially gives a carte blanche to national policy makers to spend their way out of recession Keynesian style, something that arguably most were set to do anyway. The guidelines how and when to spend it were purposefully vague, preferably ticking the boxes of timely, targeted and temporary in an official language that is reminiscent of consultancy speak. Notably, disagreements between member states over an EU-wide stimulus programme hampered attempts to forge a consensus for fiscal policy coordination. This discord did stem from the different national evaluations of the nature and scope of the crisis, as well as from widely differing fiscal stances which left national policy-makers with varying margins of maneuver.

Given that fiscal policy coordination was not working when it was concerned with curbing deficits prior to 2008, how then would it fare when all of sudden the message emerging from Brussels was; now you may actually increase your debt burdens? For the first time in EMU member states were faced with a situation where guidelines were vague, the SGP suspended, and national policy-makers expressively encouraged to run deficits. As a result member states spent as they pleased, some implementing substantial stimulus policies, others barley engaging in discretionary fiscal policy spending at all. This is one of the key lessons for fiscal policy coordination during the Great Recession of 2008-2009; fiscal policy coordination in EMU did not work, and it did not matter whether coordination was concerned with consolidation, or stimulus policies.

To understand this one has to look at an additional bias to the deficit and debt bias of contemporary policy making, - the hypocrisy bias. Virtually all member states like to sing the hymn of low deficit and debt burdens from the spreadsheet of stability culture. And if the economic climate and the political one for that matter, seems opportune they might also act accordingly. Or at least pretend they do.

In a classic collective actions setting the two disagreements, first how to actually do fiscal policy and secondly how to talk about it, pose considerable problems. EMU states are heterogenous as far as resources (in other words respecting the SGP and related rules is costlier for some member states than for others) as well as their interests (e.g. in France right now austerity is not de rigger whereas it is very much so in Germany and Austria). This makes the success of collective action unlikely. Given the difference in thought or actual production and allocation functions of the cost and benefits of fiscal policy coordination, member states display a high degree of group latency, according to Mancur Olson (1963) one of the key feature of collective action failure. The architects of EMU, saw this a long way coming and had the SGP purposefully set up to provide this very selective and separate incentive that is thought to induce group oriented behavior. Except for the fact that it was a weak instrument.

So how then to motivate this latent group and jolt it into collective action in the post-crisis context of fiscal consolidation and macroeconomic reform? Arguably the first answer is already becoming apparent and it is not found in the Treaty on Stability, Coordination and Governance, which is just the old rules dressed up in the sterner robes. Instead the real separate and selective incentive is exerted by 'market discipline' as bond market participants have awoken to the fact that EMU member states are very different indeed. In the turmoil of the Sovereign Debt Crisis with markets engaging in what some might describe as 'irrational exuberance' (Shiller 2000), consolidation of public finances in all EU member states has witnessed a tentative turnaround with an projected EU average deficit of 1.4 in 2014 (COM 2012).

Market discipline refers to the signals from the financial markets that - so the theory goes - can deter a borrower from maintaining an unsustainable path of borrowing, it is a police man against moral hazard problems described by the political economy of public deficits (Lane 1993). Looking at the development of long-term interest rate in the eurozone, the forces of market discipline seem to have been put into hibernation[1] once states joined the euro which came to an abrupt end in 2009.

By eliminating currency risk and reducing transaction costs within the eurozone, the introduction of the new European currency has considerably strengthened European financial market integration. Not to bailout another eurozone member state is hence not also politically but also economically no longer an option. This poses a challenge; for market discipline to work, a modified Art. 125 has to stay in place. That means that muddling through towards fiscal union by agreeing on one bail-out after another, has the dangers of putting market discipline back into a slumber while not setting up binding rules and considerably taking fiscal policy making, and more

[1] Schuhknecht and colleagues (2009) empirically investigate the drivers of government risk premiums in the bond market and find that the effect of the debt ratio on yield spread almost disappears with the introduction of the euro.

to the point macroeconomic management, out of the hand of national policy makers.

Instead of relying solely on peer pressure and consequently intergovernmental agreements, market pressure may be the best sanctioning system available to achieve at least a minimal form of fiscal policy coordination. Notably coordination problems are not limited to the direction of fiscal policy (spend or save), but concern all agreements that constrain public spending. Unless EMU member states converges in terms of their fiscal preferences, both in terms of political culture and economic reality, there is need to jolt this latent group via separate and selective incentives, and these are unlikely to come from within the group itself.

As a matter of course market pressure is not a panacea. The architects of EMU were skeptical of the effectiveness of market discipline in the first place and whether it could really induce member states to pursue sound fiscal policies. Not because they would not believe in the seriousness of the no bail out clause but because 'market perceptions do not necessarily provide strong and compelling signals. The constraints imposed by market forces might either be too slow and weak or too sudden and disruptive' (Delors 1989). Looking at the devastating effects of the current Sovereign Debt Crisis the evaluation of the Delors groups reads like a writing on the wall. In this light, the various proposals (e.g. Favero & Alexandra 2012, Schelkle 2012, Curzio 2011, Phoebus 2011, Delpa & Weizsäcker 2010) to mitigate the 'irrational exuberance' of market participants whilst retaining their disciplinary function should be mandatory reading for all interested in the future of EMU.

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