des données économiques

Université de Pau
et des
Pays de l'Adour

Working Papers Series

CATT WP No. 7.
November 2009

How to herd cats:
economic policy coordination in the Euro zone in tough times

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Available online at http://catt.univ-pau.fr

How to herd cats: economic policy coordination in the Euro zone in tough times[i]

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Abstract

This paper addresses the issue of fiscal policy coordination in the context of the current crisis. It first aims at clarifying the economic rationale for fiscal policy coordination in a monetary union with decentralized fiscal authorities, and at exploring the foundations of the kind of coordination devices chosen, as well as the incentives and constraints on member states' governments arising from the fiscal rules in the Euro Zone, both in tranquil and in stormy economic times. We then proceed with an analysis of the difficulties arising from the heterogeneous nature of the Euro Zone. In Section 3, we explore some of the possible causes of heterogeneity, with an emphasis on the issue of collective action and country size, with the coexistence of large and small countries, facing different incentives and constraints, hence tending to adopt divergent strategies in the occurrence of common macroeconomic shocks. Section 4 addresses the possible evolution in automatic fiscal stabilizers and Section 5 documents the size and structure of national fiscal stimulus packages. The concluding section advocates a better mix of rules and discretionary coordination for fiscal policies in the Euro Zone.

Introduction

The economic and financial crisis that has been spreading over the world economy since the beginning of 2008 has elicited strong policy reactions from national governments in almost all countries. In the immediate aftermath of the banking crisis and stock market collapse of September-October 2008, OECD countries have, for the first time in decades, announced large fiscal stimulus packages of Keynesian inspiration, while central banks have been pursuing extremely expansionary monetary policies. Yet, in spite of mounting evidence that the recession will, in 2009-2010 at least, be much more severe in the European Union (EU) than in the US, there have been no signs that additional policy measures will be implemented in European economies. Quite the contrary, on the eve of the London G20 summit of April 2, 2009, one of the major items of contention between the US government and Europeans was the size and significance of the various national fiscal stimulus plans: indeed, comparing the figures of the announced discretionary measures on both sides of the Atlantic, it appears that discretionary fiscal policies in EU member states are considerably less ambitious than what was enacted by the US Congress in February 2009.

One major difference between the US and the EU is, of course, that the latter is a collection of sovereign states, with only limited common institutions and procedures to deal with common fiscal policy. Indeed, the 2008-2009 deep recession may be regarded as the first common macroeconomic shock of large magnitude hitting the infant European monetary union –the tenth anniversary of the euro was celebrated in January 2009. In this large group of relatively small countries, macroeconomic policy coordination resorts to the logic of collective action (Olson, 1965). Factors explaining differences in incentives facing national governments should therefore be expected to play an important role in the choice of national strategies. One prominent parameter is country size, with smaller states being more tempted than larger ones by free rider strategies.

The apparent difficulties with fiscal policy coordination within the EU and, more specifically, within the Euro zone, are the topic of this paper. Hence the image of herding cats. Several questions are in effect raised: first what are the circumstances under which cats would gain from being herded; then what are the possible reasons why they are so hard to herd; and finally how could institutions be modified to make it easier to herd these cats.

This paper tries to clarify the economic rationale for fiscal policy coordination in a monetary union and to shed light on the sources of current difficulties and tensions in the field of fiscal policy in the Euro zone. In the first section, we survey the major arguments for policy coordination and discuss the possible objectives of coordination, as well as the major devices to coordinate fiscal policies. Section 2 emphasizes one important source of difficulties in the current EU configuration, namely the heterogeneity of national macroeconomic performances and initial situations, at the outbreak of the recession. Section 3 then analyzes the constraints and incentives that arise from these various tools of policy coordination, in order to better understand the choices facing national governments in such settings; we stress that country size is probably a relevant dimension to consider when analyzing the incentives facing national governments in a monetary union. In Section 4, we raise the issue of automatic fiscal stabilizers and of whether differences in their magnitude might explain the difference in discretionary fiscal stimuli. Section 5 briefly discusses the contents of existing fiscal stimulus plans of a sample of EU countries. Finally Section 6 offers some tentative conclusions about the design of rules and institutions for a better macroeconomic policy mix in the Euro Zone.

1. Economic interdependencies, the nature of shocks and the rationale for coordination

What emerges from the abundant economic literature on policy coordination is the generic idea that the need for coordination arises in contexts characterized by interdependencies, due either to collective goods or to externalities[iii]: in such contexts, decentralized decision-making in the absence of coordination devices will lead to sub-optimal, non cooperative, Nash equilibria. In a monetary union with decentralized fiscal authorities, economic interdependencies may arise from different channels. They result from the existence of collective goods, such as monetary stability or reputation on financial markets and vis-à-vis private agents in general, of public goods and common policies (defence, infrastructure building with network effects, etc.), or from spillovers, i.e. unintended consequences of national macroeconomic policies on other member states economies. Such spillover effects may be positive or negative.

1.1. Sources of interdependencies

When a group of countries participate in a regional economic integration process such as the European Union's Single market, they decide to abolish barriers to private transactions in goods, capital and, in the European case, obstacles to labour mobility, all measures fostering market integration, which in turn is likely to increase the magnitude of spillover effects resulting from the use of national economic policy tools, such as fiscal policies[iv]. Whether or not this process then spontaneously generates economic and financial convergence, intended as similarity in market conditions – prices and real incomes – as well as synchronicity and similar magnitude of business cycle fluctuations is still an open issue. Similarly, it is still unclear whether market integration, which generates a lowering of transaction costs, hence a mixture of specialization in production and agglomeration of productive activities, will make macroeconomic shocks more uniformly distributed across the whole area, or conversely more asymmetric and idiosyncratic[v].

When countries form a monetary union, they share in common a single currency, and therefore uniform nominal variables[vi] – mostly the short-term nominal interest rate, which is the main instrument in the hands of modern central banks --, which may in turn accentuate the reduction in transaction costs, hence goods and financial market integration. Monetary and financial stability of the currency area is then properly regarded as a "collective good", insofar as it primarily depends on the joint use of their single monetary instrument, event though it may also be influenced by individual countries' actions or circumstances. But members of the monetary union may also decide that other aspects of their joint venture are to be considered "collective goods", be they of the traditional, public good kind, such as defence, or simply goods for which members collectively care, such as economic growth, or even some concept of distributional justice. In all such cases, the "collective good", once it has been recognized such, is indeed a common concern and henceforth subject to all the difficulties arising in a context of interdependencies.

The theory of "fiscal federalism" (Oates, 1972 and 1999) suggests that in all cases where spillovers are of significant magnitude, the simplest way of ensuring the emergence of collective action is to deprive local, decentralized authorities from the competence over the corresponding policy instrument and to transfer it to the central government. But in the case of the EU, in contrast to what has progressively emerged in federations such as the US, there is no such thing as a significant central budget. Or rather, the EU budget is the common budget of all 27 member states, not just of the Euro zone; and it is too small and constrained by a ceiling on its overall size, with a balanced-budget rule preventing any countercyclical management at the central level. Hence, in cases when collective action is required in the field of fiscal policy, it can only emerge as the outcome of a coordination of decentralized governments.

1.2. The nature and transmission of macroeconomic shocks

But when is collective action really beneficial, and do the circumstances prevailing in 2008 correspond to such a context?

One of the numerous contributions of Optimum Currency Area (OCA) theory has been the celebrated distinction between two types of macroeconomic shocks hitting a currency union: common, or symmetric shocks, i.e. those that affect all members of the union in a similar fashion; and specific, idiosyncratic, or asymmetric shocks, i.e. those that hit only one, or a subgroup of members of the union. The conventional wisdom derived from this theory was that common shocks could be dealt with by using the only common instrument in the currency union, namely monetary policy, whereas asymmetric shocks would give rise to more trouble, because countries would no longer enjoy the benefit of independent currencies and because the channels of adjustments to such shocks might not be very effective in the case of the Euro Zone.

This seems to be the reason why much energy was dedicated to designing rules, such as the Stability and Growth Pact (SGP), that essentially aim at preventing national governments of individual countries from adopting divergent, "harmful" fiscal policies[vii]. And conversely, not much had been put in place for the occurrence of common shocks, under the assumption that monetary policy alone could handle them. It is true that Broad Economic Policy Guidelines (BEPG) were instituted to make sure that at least some degree of coherence in national macroeconomic policies –fiscal policies and supply-side measures—is maintained. But BEPG are mostly concerned with medium-term strategies, and cannot be relied upon as a coordination device in the face of a sudden common shock calling for immediate action; it also appears that BEPG have been only moderately successful as an instrument of coordination[viii]. Not much attention was paid to the possibility of having to face a common macroeconomic shock: in the first version of the SGP, special circumstances that could excuse exceeding the 3%-of-GDP ceiling for budget deficits were defined as a more than 2% recession; but it was widely held most unlikely.

Conventional wisdom also implicitly assumed that monetary policy would suffice to deal with common macroeconomic shock in the unlikely occurrence in which they might materialize. But the experience of Japan in the 1990s should have taught policy makers that there are circumstances in which monetary policy can no longer be relied upon, because it becomes ineffective due to the "zero barrier" –or "liquidity trap" in the language of old Keynesian economics—that prevents central banks from lowering real interest rates when inflation rates are close to zero or indeed negative. And for the first time since at least the Second World War, such a situation occurred in the Euro zone, as well as in the US and the UK. Whereas monetary policy alone can deal with common inflationary shocks, it cannot fight deflationary shocks of a large magnitude. In such cases, an appropriate policy mix is required, whence aggregate fiscal policy plays a major role.

At first sight, the 2008-2009 crisis should be regarded as a –large-- common negative shock, in the terminology of the OCA theory. But is it really so? Or at least, was it perceived as such by national governments? Looking at the timing of quarterly macroeconomic evolutions, there are signs that the impact of the global crisis was not synchronized amongst EU members, and that the time lags may help understand some significant differences in national fiscal policy reactions. Table 1 indicates the quarterly changes in real GDP, as published by Eurostat in early 2009. Focusing on larger EU members, it shows that, for instance, Germany enjoyed a very buoyant growth in the first quarter on 2008, while France, as well as most other European countries, was experiencing a marked slowdown in economic growth. In the last quarter of 2008, the opposite happened, the slowdown in Germany being much steeper than in France, which may explain why

the French government decided not to add to the already announced fiscal stimulus plan, whereas the German government went for additional spending in February 2009.

[Table 1, approximately here]

1.3. Macroeconomic spillovers from fiscal policies

Because the European monetary union was conceived at a time when monetary stability was widely held to be the single, most desirable objective, and with the aim of minimizing centralization, i.e. transferring only monetary powers at the supranational level, while leaving most attributes of economic sovereignty, especially fiscal and tax policies, in the hands of national governments, interdependencies stemming from the use of these instruments were given most attention in the debate over economic policy coordination. But due to the belief that large common negative shocks were not likely, the emphasis was put on fiscal rules, rather than on instruments to promote positive coordination.

Macroeconomic spillovers from national fiscal policies in a monetary union arise as a consequence either of market integration or, due to monetary integration, of the interactions between the aggregate outcome of decentralized fiscal policies and the central bank's decision process. Let us focus on the first category, such spillovers may be either positive –the so-called traditional Keynesian spillovers, that result from the multiplier effects of fiscal policies and their "locomotive effects" through trade– or negative, mostly through the consequences of deficit financing on financial variables, be they interest rates or exchange rates.

A major indicator of the strength of traditional, Keynesian interdependencies is the degree of trade openness[ix]. As is apparent from Table 2, the situation of EU members on the eve of the current crisis was, in this regard, contrasted, with most larger countries only moderately open, while smaller ones were, on average, much more open to trade, albeit with a few exceptions (Greece and Portugal, in particular).

[Tables 2 and 3, and Chart 1, approximately here]

An additional piece of evidence is provided by the change over time in the trade openness ratio, shown in Chart 1 for a selection of EU member states. In most smaller countries, not only was this ratio already high in the mid-90s, but it has been steadily rising since then, while the ratio has been mostly flat, and much lower, for all but one larger EU members, the exception being Germany.

The rationale for the SGP, the rule imposed in the Amsterdam Treaty on national fiscal policies[x], is directly inspired by the assumption that such trade spillovers are relatively negligible, compared to other sources of, this time negative, spillovers arising in a monetary union whose priority in monetary stability. The latter tend to result from the weakening of discipline devices bearing on national fiscal policies for countries forming a currency union and from the nuisances that are inflicted on partners in the union by over-expansionary, and possibly unsustainable, national fiscal policies[xi].

Economic theory suggests that positive spillovers or collective good situations should be dealt with by a centralized authority or other devices that foster collective action, either by common policy instruments or by incentives for decentralized decision-makers to act in the common

interest, whereas negative spillovers can in principle be fought either by negative incentives or by the adoption of rules imposing limits and constraints on national fiscal policies, in order to prevent the nuisances arising from "bad behaviour" and "excessive public deficits". But these rules have a cost, in terms of lost opportunities or reduced flexibility, and they should be properly directed at making national fiscal policies sustainable, not necessarily through an upper limit on current deficits[xii].

2. Heterogeneity in the Euro zone

Part of the difficulty in agreeing on common macroeconomic orientations may arise from differences in initial conditions, and in perceived margins of manoeuvre. Indeed, in spite of efforts during the transition phase to economic and monetary union, especially through the imposition of convergence criteria –the so-called Maastricht criteria--, the economies of the Euro zone have proved much more heterogeneous than had been expected. This is clearly shown in the standard macroeconomic performance indicators, especially measures of economic growth, long term real interest rates and public finance indicators, as well as in the current account positions of the various member states (Tables 4 to 7). How to explain such heterogeneity? That it may result from asymmetric shocks seems hard to believe, although there have undoubtedly been some divergences in domestic policy orientations. But whatever the sources of such divergences, they have, in the Euro zone, yielded different monetary conditions in the member states: in the last decade, under monetary union, with identical nominal short-term interest rates and, until recently, almost equal long-term ones, differences in domestic inflation rates were reflected in different real interest rates; and lower real rates not only tend to boost economic growth by making investment and private indebtedness less costly, but also reduce the real burden of existing public debt, thus easing the task of fiscal policy making.

[Tables 4 to 7, approximately here]

3. Possible causes of macroeconomic heterogeneity: Small and large states coping with differences in incentives

Although the equal treatment principle is deeply entrenched in the democratic ideals and widely regarded as the only fair organization rule in a democracy, there seems to be a problem with the "one-size-fits-all" principle in the field of fiscal policy rules in the EU. In particular, the implementation of the SGP has shown weaknesses that have been clearly correlated with country size: thus, in 2004, all four large countries of the EU had budget deficits above the 3%-of-GDP ceiling; and will again in 2009. The 2004 episode, as well as the conflict over qualified majority rules that forestalled the adoption of the constitutional treaty project, have revealed a profound cleavage between small and large countries in the EU, a distinction that had never been apparent before. For scholars of the history of federal states and institutions, especially of the United States of America, this should not come as a surprise (see Laurent and Le Cacheux, 2004).

Nor indeed for economists, as it has long been emphasized that in contexts of "collective action", size matters and smaller players are more likely to free-ride and exploit larger ones (Olson, 1965), and can easily be shown, the incentives –costs and benefits of various courses of action-- facing a small open economy are not at all the same as the ones facing a medium-sized one, such as Germany or France, which may help explain the differences in performances and strategies that seem so systematic in the recent history of the euro zone.

For a small open economy, traditional fiscal policy of the Keynesian kind will usually be of limited effectiveness, whereas all policies that improve the competitiveness of the national economy by lowering production costs of firms located in the domestic economy are relatively more powerful: this may explain why fiscal consolidations in small countries have been found to have "non-Keynesian" effects (see Giavazzi and Pagano, 1996); it also suggests that tax competition, "structural reforms" and wage moderation policies will all have very powerful, positive effects for a small open economy, both because exports represent a major fraction of demand to domestic firms and because the elasticity of the supply of external capital – in particular foreign direct investments – is higher, the smaller and the more open the economy is. In addition, policies that lower production costs in a small economy do not harm domestic demand very much, and they have little incidence on domestic inflation, so that they do not raise real interest rates, as nominal rates in a monetary union tend to be uniform across countries and to be relatively little influenced by the policies of a single, small country[xiii].

For large countries, on the contrary, free riding is almost impossible, and the various policy choices reviewed above tend to be more costly, or even counterproductive. Traditional, Keynesian-style demand-management policies, especially fiscal policies are more efficient than for a small open economy, because demand spillovers are relatively lower. On the other hand, all policies tending to lower production costs are less effective, and they all tend to lead to a lower domestic inflation, which then results in a higher real interest rate, so that they tend to be costly in terms of economic activity and growth. The contrasted fates of Germany and Ireland over the past few years seem to be a perfect illustration of this difficulty of large countries in an economic and monetary union (Laurent and Le Cacheux, 2007).

4. Automatic fiscal stabilizers

But aren't cats herded enough after all? In the weeks preceding the G20 summit in London, the controversy between the US government and EU national governments over the required size of national fiscal stimulus packages revolved around the magnitude and potential effectiveness of automatic fiscal stabilizers: whereas the US discretionary fiscal stimulus was, indeed, much larger than the announced EU plans. Europeans pointed to the allegedly much larger automatic fiscal stabilizers existing in Europe, with the implication that they needed not do as much as the US federal government in terms of discretionary fiscal stimulus.

This dispute over automatic fiscal stabilizers is reminiscent of some of the European controversies over the SGP: in the minds of defenders of the SGP, with national budgets at or close to balance on average over the economic cycle, 3% of GDP was regarded as a sufficient margin of manoeuvre for national fiscal policies faced with the usual economic downturns; and this magnitude was deemed to correspond, at least roughly, to the size of automatic fiscal stabilizers incorporated in European national public sectors.

In theory, in the context of monetary unions and according the standard OCA theory arguments, one should distinguish between automatic stabilizers embedded in the functioning of the central budget (Sachs, 1992; Zumer, 1998; Melitz and Zumer, 2000), and those arising from the functioning of national public sectors. With regard to the first category, it is well known that the EU budget is both too small and little sensitive to cyclical fluctuations to play a significant role, whereas the US federal budget has been shown to act as an automatic cushioning mechanism in case of asymmetric shocks occurring within the US economy. But it is nonetheless the case that the state and local public sectors pursue highly pro-cyclical fiscal policies in the US, for various reasons, including the institutional setting in which state and local fiscal policies are decided: in this respect, it may be argued that the magnitude of the discretionary federal fiscal stimulus is, at

least in part, aimed at counteracting the pro-cyclicality of state and local fiscal policies (Le Cacheux, 1983; Schelkle, 2009).

What about the magnitude of automatic fiscal stabilizers embedded in European national public sectors? At first sight, they may look larger, insofar as the size of public sectors and the extent of social welfare devices are much larger on average in EU countries than in the US. However, it is also the case in Europe that local public sectors tend to behave pro-cyclically, even though this is probably less documented than in the US. And there is evidence that, over the past decades, general governments' budgets have evolved toward lesser automatic stabilizers (Solow, 2004; Creel and Saraceno, 2008): (personal and corporate) income tax schedules have become less progressive, while in many countries the generosity and length of various counter-cyclical, welfare devices –and most prominently unemployment benefits—have been significantly reduced. How important is this reduction in the magnitude of automatic stabilizers is hard to assess precisely.

5. The heterogeneity of national fiscal stimulus packages

Table 8 gives the composition of fiscal stimulus plans in a selection of EU countries[xiv]. Whereas it provides only mixed evidence on the effect of country size on national fiscal policy choices, it clearly supports the view that national discretionary measures are very heterogeneous, both in size and in the precise targeting of sectors and types of expenditures. In particular, the UK appears to be the only country to have resorted to an across-the-board measure to support private domestic consumption, a VAT temporary cut, which, if effective at all, will benefit foreign as well as domestic producers; by contrast, all other countries featuring in the table –all members of the Euro zone, incidentally—have tended to favour stimulus measures targeted at home producers, such as public investment. But, as shown in Table 9, the sizes and composition of national fiscal stimulus plans are not such that any defined pattern emerges, except for the fact that they definitely are smaller than the one enacted in the US.

[Tables 8 and 9, approximately here]

6. Concluding remarks: fiscal policy coordination without a **gouvernement économique**

As abundantly illustrated by the vicissitudes of the Stability and Growth Pact and by the poor performance of the economies of Euro zone over the past few years, fiscal policy coordination is still embryonic and not very satisfactory in the European monetary union, after more than ten years of existence of the European currency. Though not really surprising, when considered in a historical perspective –it took much more than ten years for the US Federal Reserve System, created in 1913, and the Federal government to set up the subtle mechanisms of macroeconomic management that are now seen to operate in the US economy - this difficulty is clearly hampering the achievement of other goals and negatively affecting the whole process of institution-building and integration in the EU. This lack of coordination appears especially costly in the current crisis, with the prospects of a very deep and protracted recession, followed by a very shallow recovery in the Euro zone.

Because of the still very large divergences in preferences and perceptions of costs and benefits of the various possible strategies for fiscal policies, and more generally for economic policy-making amongst member governments of the Euro zone, the prospects for a genuine economic government of the Euro zone are rather gloomy. It is therefore not surprising that in the face of the massive recession that has hit the EU economies, coordinated policy responses have not

easily been forthcoming. This is all the more problematic as an appropriate aggregate fiscal orientation, as well as an appropriate macroeconomic policy mix, would probably prove more effective in fighting the recession than disorderly national policy responses that seem to be inspired, at least in part, by free-riding considerations. And although all EU governments are now facing very similar fiscal circumstances – high public deficits and sharply increasing public debt ratios - it seems unlikely that cats will be more easily herded when it comes to public finance consolidation plans.

In the absence of a genuine *gouvernement économique*[xv] that would in some way aggregate preferences over common rules and collective goods and make use of policy instruments to ensure their provision, there may be ways to improve on the current performance within existing institutions. In 2005, in response to difficulties in the implementation of the SGP, the latter was reformed and notably improved to face small, idiosyncratic shocks. But this is clearly insufficient to elicit coordinated fiscal policies in much stormier economic times. A more ambitious reflection would try to explore the possibilities of developing federalism, either by embarking on a reinforcement of the central EU budget along the lines once suggested by the MacDougall Report (EC Commission, 1977) or, more realistically perhaps, to devise an original brand of highly decentralized federalism, which may be labelled "Pigouvian federalism" (Le Cacheux, 2004), in which the central budget would remain relatively small, but where an appropriate mix of rules – with desirable features, such as an amended "golden rule" of public finance, whereby expenditures to be encouraged are not counted in the agreed deficit ceiling or target -- and financial incentives, in the European budget, is set up in order to induce national governments to undertake actions that are collectively considered to be in the common interest.

Table 1: GDP growth rates in EU countries, quarterly profiles

Percentage change compared with the previous quarter							Percentage change compared with the same quarter of the previous year	
2008							2008	
Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	
EA15	0.7	-0.2	-0.2	**-1.5**	2.1	1.4	0.6	**-1.2**
EU27	0.6	0.0	-0.2	**-1.5**	2.3	1.7	0.8	**-1.1**
EA16	0.7	-0.2	-0.2	**-1.5**	2.1	1.5	0.7	**-1.2**
Member States								
Belgium	0.4	0.3	0.1	**-1.3**	1.9	1.9	1.2	**-0.5**
Bulgaria**	:	:	:	**:**	7.0	7.1	6.8	**:**
Czech Republic	1.0	1.0	0.9	**-0.6**	4.9	4.6	4.2	**1.0**
Denmark	-1.2	0.4	-0.4	**:**	-0.7	0.6	-1.3	**:**
Germany	1.5	-0.5	-0.5	**-2.1**	2.8	2.0	0.8	**-1.6**
Estonia**	-1.2	-1.5	-0.9	**:**	0.2	-1.1	-3.5	**:**
Ireland	-0.3	-0.6	1.2	:	-1.2	-0.7	0.1	**:**
Greece	0.8	1.1	0.5	**0.3**	3.1	3.5	2.9	**2.6**
Spain	0.4	0.1	-0.3	**-1.0**	2.7	1.8	0.9	**-0.7**
France	0.4	-0.3	0.1	**-1.2**	2.1	1.2	0.6	**-1.0**
Italy	0.4	-0.6	-0.6	**-1.8**	0.3	-0.4	-1.1	**-2.6**
Cyprus	1.0	0.8	0.6	**0.6**	4.1	4.0	3.5	**3.0**
Latvia**	-7.4	1.3	1.1	**:**	0.5	-1.9	-5.2	**-10.5**
Lithuania	-0.3	1.0	0.3	**-2.4**	7.0	5.3	2.8	**-1.4**
Luxembourg	-0.8	1.5	-1.4	**:**	0.9	2.4	0.0	**:**
Hungary	0.5	0.0	-0.5	**-1.0**	1.4	1.5	0.5	**-1.0**
Malta	0.2	1.0	0.1	**:**	3.1	3.6	2.5	**:**
Netherlands**	0.5	-0.1	-0.3	**-0.9**	3.6	3.3	1.9	**-0.6**
Austria	0.5	0.2	0.0	**-0.2**	2.5	2.1	1.4	**0.5**
Poland	1.2	1.3	1.2	**:**	6.1	5.8	5.6	**:**
Portugal	-0.3	0.3	-0.1	**-2.0**	0.9	0.6	0.5	**-2.1**
Romania**	:	:	:	**:**	8.2	9.3	9.1	**:**
Slovenia	1.9	0.5	0.7	**:**	5.9	4.7	3.5	**:**
Slovakia**	-3.3	1.9	1.9	**2.1**	9.3	7.9	6.6	**2.7**
Finland	0.2	0.5	0.1	**:**	2.6	2.2	1.4	**:**
Sweden	0.0	-0.1	-0.1	**:**	1.7	0.7	0.3	**:**
United Kingdom	0.4	0.0	-0.6	**-1.5**	2.6	1.7	0.3	**-1.8**
EFTA countries								
Iceland	-1.6	4.7	-3.4	**:**	3.2	4.7	-0.8	**:**
Norway	0.2	0.1	-0.7	**:**	3.6	3.0	0.6	**:**
Switzerland	0.3	0.3	0.0	**:**	3.1	2.5	1.7	**:**
Main economic partners								
United States	0.2	0.7	-0.1	**-1.0**	2.5	2.1	0.7	**-0.2**
Japan	0.6	-1.0	-0.5	**:**	1.4	0.6	-0.3	**:**

Source: EU Commission, February 2009 forecasts.

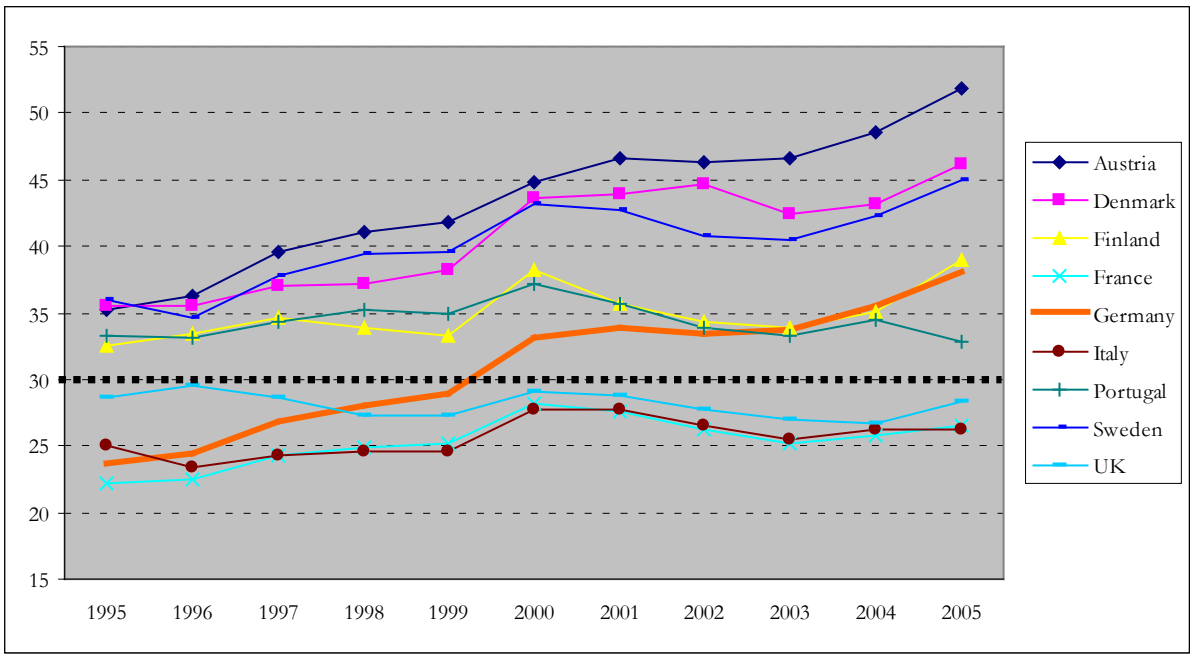
Table 2: Trade to GDP in 2005 for OECD countries

United States	13,4
Japan	13,6
Australia	21
Greece	22
Italy	26,3
France	26,6
Spain	28,2
United Kingdom	28,3
New Zealand	29,1
Mexico	30,7
Turkey	30,7
Portugal	32,9
Canada	36
Norway	36,7
Poland	37,2
Germany	38,1
Iceland	38,3

Finland	39
Korea	41,2
Switzerland	44,5
Sweden	44,9
OECD average	45
Denmark	46,2
EU15 average	50,7
Austria	51,9
Netherlands	66,1
Hungary	67,1
Czech Republic	70,8
Ireland	**74,9**
Slovak Republic	79,8
Belgium	86
Slovenia	129,7
Luxembourg	148,6

Source: OECD.

Chart 1: Trade to GDP ratio for selected EU member states, 1995-2005



Source: OECD, and Laurent and Le Cacheux, 2007.

Table 3: First 15 trade partners of Germany in 2005

Exports	**912,2**	%	**Imports**	**796,2**	**%**
France	79	8,7	France	53,7	6,7
US	69,3	7,6	Netherlands	51,8	6,5
UK	60,4	6,6	US	41,8	5,2
Italy	53,9	5,9	China	40,8	5,1
Netherlands	49	5,4	UK	39,1	4,9
Belgium	43,6	4,8	Italy	36,3	4,6
Austria	43,3	4,7	Belgium	28,8	3,6
Spain	40	4,4	Austria	26	3,3
Swiss	29,6	3,2	Swiss	22,6	2,8
Poland	22,3	2,4	Russia	22,3	2,8
China	21,2	2,3	Japan	21,8	2,7
Russia	17,3	1,9	Spain	18,1	2,3
Tch. Rep.	19,2	2,1	Tch.Rep.	17,7	2,2
Sweden	17,2	1,9	Poland	16,8	2,1
Hungary	13,6	1,5	Norway	15,1	1,9

Source: Destatis, and Laurent and Le Cacheux, 2007.

Table 4: GDP growth rates in Euro Zone countries, ten-year averages

	Average 1979-1988	Average 1989-1998	Average 1999-2008
AUT	2,21	**2,66**	2,27
BEL	2,04	2,09	**2,27**
DEU	1,97	**2,52**	1,56
ESP	2,22	2,69	**3,54**
FIN	**3,70**	1,74	3,36
FRA	**2,24**	1,96	2,16
GRC	0,73	1,95	**4,15**
IRL	2,84	**6,58**	5,85
ITA	**2,78**	1,58	1,36
LUX	3,81	**4,93**	4,88
NLD	1,72	**3,17**	2,35
PRT	**3,27**	3,17	1,70
EURO	2,23	**2,25**	2,12
Ecart-type	**0,87**	1,47	1,41

Table 5: Current accounts in Euro Zone countries, (% of GDP, ten-year averages)

	Average 1979-1988	Average 1989-1998	Average 1999-2008
AUT	-0,43	-1,20	**0,57**
BEL	0,52	**4,68**	3,26
DEU	1,43	0,12	**3,23**
ESP	**-0,57**	-1,73	-5,90
FIN	-1,42	-0,07	**5,93**
FRA	-1,10	**0,48**	0,42
GRC	-4,58	**-3,28**	-8,75
IRL	-6,19	**1,42**	-2,00
ITA	-0,74	**0,49**	-1,26
LUX			
NLD	2,17	4,11	**5,17**
PRT	-3,41	**-2,01**	-9,13
EURO	0,05	0,26	**0,31**
Ecart-type	2,52	**2,44**	5,27

Table 6: Real long-term interest rates in Euro Zone countries, ten-year averages

	Average 1979-1988	Average 1989-1998	Average 1999-2008
AUT	4,32	4,40	**2,60**
BEL	5,81	5,20	**2,27**
DEU	4,80	4,15	**2,81**
ESP		5,03	**1,16**
FIN	2,91	6,62	**2,65**
FRA	4,32	5,27	**2,61**
GRC	**-1,75**	5,58	0,66
IRL	3,53	5,47	**0,70**
ITA	2,79	6,18	**2,22**
LUX	5,83	4,20	**0,97**
NLD	5,22	4,61	**2,15**
PRT	4,04	6,76	**1,55**
EURO			2,21
Ecart-type	2,11	0,89	**0,81**

Table 7: Public deficits in Euro Zone countries, (% of GDP, ten-year averages)

	Average 1979-1988	Average 1989-1998	Average 1999-2008
AUT	-3,26	-3,41	**-1,51**
BEL	-10,61	-5,26	**-0,27**
DEU	-2,39	-2,40	**-1,99**
ESP	-4,72	-4,78	**0,15**
FIN	3,49	-1,84	**3,87**
FRA	**-2,15**	-3,90	-2,68
GRC	-7,09	-9,26	**-4,25**
IRL	-10,27	-1,43	**1,35**
ITA	-10,46	-8,39	**-2,80**
LUX		2,15	**2,27**
NLD	-4,62	-3,18	**-0,32**
PRT	-6,62	-5,12	**-3,41**
EURO	-4,54	-4,22	**-1,74**
Ecart-type	4,30	3,06	**2,44**

Sources of Tables 4 to 7: OECD, calculations by Jérôme Creel., and Fitoussi and Le Cacheux, eds., 2009.

Table 8: National fiscal stimulus plans in a selection of EU countries, as of January 2009

Source: Natixis, compiled from national sources.

Bn €	UK	Germany	France	Italy	Spain
Housing	2.1	1.8	1.8	0.3	0.5
Public infrastructures	1.2	4.6	10.5	1.4	8.0
Private investment incentives	0.5	19.5	10.7	1.2	7.3
Incentives to buy durable goods		3.5	1.0	2.6	1.8
Private consumption support	15.0	0.5	1.5		0.6
Public consumption	1.2	2.0			0.9
Total (bn €)	20.0	31.9	25.5	5.5	19.1
Total (% of GDP)	1.2	1.3	1.3	0.4	1.7

Table 9: Automatic and discretionary variations in fiscal balances in the 11 original Euro zone members*

(% of GDP)

	Observed		Impact of recession		Discretionary package		Total fiscal balance**	
	2007	2008	2009	2010	2009	2010	2009	2010
Austria	-0.4	-0.6	-3.1	-5.1	-1.3	-0.9	-4.7	-6.0
Belgium	-0.2	-1.2	-3.7	-4.7	-1.0	-0.6	-4.8	-5.3
Finland	5.2	4.1	0.5	-1.5	-1.5	-0.5	-1.1	-2.2
France	-2.7	-3.4	-5.5	-7.7	-1.6	-0.6	-7.2	-8.3
Germany	-0.2	-0.1	-3.4	-4.7	-1.5	-2.0	-5.0	-6.7
Greece	-3.6	-5.0	-6.9	-8.5	0.0	0.0	-7.1	-8.6
Ireland	0.2	-7.1	-12.8	-12.3	3.2	1.9	-10.0	-10.5
Italy	-1.5	-2.5	-5.5	-6.0	-0.2	-0.1	-5.8	-6.1
Netherlands	0.3	1.0	-1.6	-2.3	-1.0	-0.5	-2.5	-2.8
Portugal	-2.6	-2.6	-5.4	-7.1	-1.3	-0.4	-6.6	-7.5
Spain	2.2	-3.8	-6.8	-10.5	-2.0	-1.0	-9.0	-11.5
Euro zone	**-0.6**	**-1.9**	**-4.8**	**-6.4**	**-1.0**	**-0.7**	**-5.8**	**-7.1**

* Excluding Luxembourg and including Greece, who joined in January 2002.
** Including interest payments

Source: Barclays, *Euro Area Government Monitor*, July 2009.

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[i] Third draft. Comments on a previous version by Iain Begg, Reinhard Felke, Eric De Souza, and participants in the EU-CONSENT Workshop, Brugge, April 7-8, 2009, as well as two referees from this *Journal*, are gratefully acknowledged. Research collaboration with economists of OFCE, especially Jérôme Creel and Eloi Laurent, have also been important in feeding my reflection. Of course, I remain the sole responsible for any remaining error.

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[iii] Rather than a clear-cut distinction between these two generic situations of interdependencies, they may be thought of as pertaining in a continuum, as convincingly advocated by Buchanan (1968), who also points to the similarities between public goods and "club goods", here aggregated under the label "collective goods", and to the subjective nature of such economic interdependencies, insofar as they may not be purely "technological", but may also be generated by perceived interdependencies of individuals' (actors') utility functions.

[iv] This is of course reminiscent of the well-established tradition of functionalist analysis of regional integration processes, which does not have to be teleological, as the rest of this chapter endeavours to show.

[v] As emphasized in the economic literature of "optimal currency areas" (OCA), initiated by Mundell (1961), the nature of macroeconomic shocks, and most importantly the distinction between common, or symmetric, and idiosyncratic, or asymmetric shocks, is a major dimension of the analysis of stabilization policies in a monetary union. See below.

[vi] But not necessarily monetary conditions and all nominal variables: in particular, inflation rates will usually differ amongst countries in a monetary union, as will be made clearer in the following.

[vii] On OCA implications for the Euro Zone, one may refer to Obstfeld and Peri (1998). On the Commission view, see Buti and Sapir (1998). On the rationale for the Stability Pact, see, in particular, Buiter, *et al.* (1993), Le Cacheux (2007).

[viii] On the functioning of the BEPG, see the recent paper by Deroose, Hodson and Kuhlmann (2008) and the numerous references therein. Their overall judgement is moderately positive, but they don't raise the issue of coordination in the face of large common shocks.

[ix] Of course, rather than measuring a country's total trade with the rest of the world, it would be preferable to focus on intra-European trade. But because the average share of intra-European trade is approximately 2/3, the rough indication given with total trade is sufficient. An indication is given for the case of Germany in Table 3.

[x] The Stability and Growth Pact was conceived as a sequel of the so-called "Maastricht criteria", asset of conditions that had meant to secure convergence of public finances amongst the EU countries before the creation of the monetary union. The Pact, instead, is a permanent fiscal rule adopted in June 1997 in a Protocol of the Amsterdam treaty.

[xi] On the rationale for "rules rather than coordination", a more detailed analysis in offered in Le Cacheux (2007).

[xii] There has been a very abundant literature on the merits and inconveniences of a ceiling on public deficits, such as included in the Stability and Growth Pact, following the critical piece on the "Maastricht criteria" by Buiter *et al.* (1993). See, for instance, Eichengreen and Wyplosz (1998). For recent assessments, see the collection of papers in Farina and Tamborini, eds., 2008.

[xiii] The notion of "small, open economy" also refers to the idea that it has no influence on its environment, therefore is a "price taker" and, in game theory terms, chooses strategies without caring about possible reactions or retaliation from partners. Our arguments are also somewhat reminiscent of, though different from the well-known result of trade theory, namely that small countries gain from a unilateral tariff reduction, whereas larger countries are likely to lose. Another way of putting the argument would be to say that a small country faces a

much more elastic supply of foreign capital and/or firms that a large one, or else that the former faces a much more favourable Laffer curve than the latter.

[xiv] Additional evidence may be found in Saha and von Weizsäker (2009). They refer to those measures of national fiscal stimulus packages taking effect in 2009, and their figures are not fully consistent with those in the table.

[xv] On this notion, see various other contributions in Linsenmann, Meyer and Wessels, eds., 2007, as well as Commissariat général du Plan, 1999.