OBSTACLES TO MACROECONOMIC COORDINATION IN EUROPE

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INTRODUCTION

International economic cooperation has often been used as a generic term encompassing a wide variety of forms of cooperation between sovereign states [Artis and Ostry, 1986]. At one end, lies the undemanding sharing of information. More ambitious are regular consultations, international surveillance, the provision of financial assistance, or the application of some agreed international rule [Horne and Masson, 1988]. The most binding form of cooperation is policy coordination which "involves mutually agreed modifications in the participants' national policies" [Kenen, 1988, p.74].

The EEC would seem to be an area ideally suited to cooperation in all these forms. There is little doubt that the EEC countries are "structurally" and "policy" interdependent [Cooper, 1985, pp.1199-200]. Policy design in France will depend on the policies taken in Germany, and *vice versa*; economic events in Britain or Italy will influence economic events elsewhere, and so on. Economic theory suggests that in such circumstances countries can improve their welfare by cooperating [Hamada, 1985]. And the likelihood of theory being put into practice is reinforced, in the European context, by the presence of only a small number of major "players", by an acute awareness of interdependence, by the frequent sharing of similar problems and by the existence of common institutions. The literature on economic cooperation suggests that all these are features which should facilitate international agreements.

In such circumstances, it is not surprising that a large degree of cooperation has been instituted in Europe. Since 1958, the EEC countries have come together in countless areas, of which the setting up of the Common Market was the first and the signing of the Single European Act has been the latest. Broadly, however, cooperation so far has worked more through the setting of rules than via common discretionary action that would not have been taken in isolation. There is a widespread perception that cooperation of the latter kind has been absent from the EEC's agenda, particularly in the 1980s, despite the numerous calls made for concerted fiscal reflation to diminish unemployment.[1]

This paper looks at whether and why EEC governments may have shied away from cooperating in the macroeconomic arena, particularly in the use of discretionary fiscal policies, and particularly in the 1980s. After a bird's eye view of past cooperation in the first section, Section II surveys some of the theoretical and empirical obstacles that may have prevented intra-EEC cooperation, while Section III examines more closely one specific problem that may have impeded coordination in Europe in the recent past - the extraordinarily different positions taken by member countries in the 1980s on the effectiveness of fiscal policy. A concluding section summarizes the arguments and provides a few pointers for the future.

I. PAST COOPERATION

As suggested in the Introduction, the revealed preference of EEC members in the area of policy cooperation so far seems to have been for rules rather than for discretion. The countries which founded or joined the Community have clearly been ready to accept restrictions on their freedom of action at home in exchange, presumably, for the gains of greater integration and of a stabler international environment. The historical origin of this preference for rules (and, ultimately, for a federal solution), can probably be traced to the perceptions of early post-war Europe and, in particular, to the lack of confidence and weakness which characterized France, Germany and Italy at the time.

Be this as it may, the acceptance of rules was true already for the EEC's forerunner, the ECSC, has been true for many of the provisions of the Treaty of Rome which have imposed elements of supranational legislation (e.g. in the area of competition law), and has continued to be true for the countless regulations with which Brussels has, over the last thirty years, tried to harmonize and bring together member countries' laws, practices and institutions in areas as diverse as transport, social or industrial policies. Rules are also at the basis of what many consider the EEC's two most important achievements - the customs union and the Common Agricultural Policy - and underlie the moves now under way towards a single European market in the early 1990s. It is true that in both trade and, particularly, agriculture, some discretion is maintained. This discretion is limited, however, by the collective nature of the decision-making process.

A similar form of what has been called "institutionalized cooperation" [Padoa Schioppa, 1985], characterizes the main example so far of EEC coperation in the macroeconomic area - the establishment of the European Monetary System. The EMS is clearly a rule-based regime since, by subscribing to certain rules of conduct, member countries have surrendered some of their sovereignty over economic matters in the pursuit of two common goals - inflation control and exchange rate stability. At the same time, however, discretion is maintained since realignments are permitted and have occurred with much greater frequency than under the Bretton Woods system. Interestingly, however, while the first three realignments were decided unilaterally, subsequent ones have all been subject to a collective decision-making process [Padoa Schioppa, 1985].

The consensus verdict on the EMS is that it was broadly successful both in bringing down inflation and in achieving a measure of convergence in countries' monetary policies. Indeed, many now see it as a likely forerunner of more ambitious attempts to move towards some form of monetary union. Additional praise of the EMS has also taken the form of arguing that it achieved what earlier had not been obtained - genuine macroeconomic policy coordination. Criticism, on the other hand, has often been levelled at the EMS's implicit deflationary bias because of the dominant and very orthodox position of Germany.

Yet, neither of these two arguments is fully convincing. Though policies under the EMS converged, that is not the same as saying that they were coordinated. It is true that countries did intervene to maintain exchange rates between realignments (a form of coordination), but this intervention was highly asymmetric - Germany and the Netherlands hardly intervened at all, while Belgium and France intervened a good deal [Giavazzi and Giovannini, 1987].[2]

As for the system's deflationary bias, this overlooks how the EMS has worked in practice. It is true that the "weaker" members of the group, such as France and Italy, by accepting a near-fixed exchange rate discipline, were forced to align their monetary policies to that of the "stronger" economies. But, by the same token, a country like Germany must have accepted, if only at the margin, some loss of policy autonomy, since it must have acquiesced, between realignments, to a somewhat lower exchange rate than it would otherwise have had.

So far the argument only suggests that despite asymmetric interventions, there was some symmetry in the ultimate effects on prices and quantities, as one would expect in a fixed exchange rate regime. But if, as has often been advanced, the credibility of the French and Italian EMS committments favourably influenced the behaviour of domestic price- and wage-setters, then these two countries may have achieved reductions in their inflation rates at a smaller cost in terms of foregone output and employment than if they had attempted the same deflation alone [Russo and Tullio, 1988]. At the same time, Germany, by accepting temporary bouts of

Deutschmark undervaluation, presumably experienced a somewhat faster growth rate than it otherwise would have had. In the absence of the EMS, in other words, all three countries might have grown more slowly - Germany because its currency would have been stronger, France and Italy because they would have had to curb an even higher rate of inflation without the benefit of an equally credible exchange rate committment.

To this beneficial impact should also be added two further EMS achievements that have, by now, been amply documented - the declines in both exchange rate and interest rate variability that have occurred in the area in the 1980s. In the presence of risk aversion, both of these must have further contributed to greater output and foreign trade growth than there would otherwise have been. Contrary to widespread opinion, therefore, the net bias of the system may well have been expansionary, at least in the initial years of operation, when the policy priority in France and Italy was inflation control.

II. SOME OBSTACLES TO POLICY COORDINATION

The preceeding section has shown that cooperation based on rules, or on a mixture of rules and (usually collective) discretion, has been an almost permament feature of the EEC. With the exception of the EMS, however, this cooperation has been limited to sectoral (or microeconomic) issues. What seems to have been surprisingly absent has been discretionary macroeconomic policy coordination. There was virtually none in the 1960s, a period in which it was the Group of 10 (for the GAB agreements), the IMF (for SDR creation), or the OECD (for the informal contacts and pressures that may have modified countries' macroeconomic policies at the margin) that were organizing what cooperation existed. There was hardly any in the 1970s, despite the shocks of that decade - the Smithsonian was clearly an affair that transcended the EEC, while the 1978 agreement on concerted reflation was much more the product of the Bonn Summit than of the prior intra-EEC Bremen meeting. And this lack of coordinated efforts continued in the 1980s despite the existence of a common and very serious unemployment problem.

It is unlikely that this opposition to policy coordination came from mutual distrust. The danger of reneging, though often stressed in the theoretical literature on international economic cooperation, would seem to carry much less weight in the real world. Cheating may be a first best strategy in one-off games, but becomes an inferior one when negotiations are carried out almost continuously and in many different areas at the same time. The EEC countries discuss with each other plans for monetary union, regional policies or high-tech ventures, they negotiate on agricultural prices, they try to present common fronts on foreign and trade policies, etc. Whatever the hypothetical gains of cheating on, for instance, a particular macroeconomic commitment, these would quickly be outweighed by the loss of reputation and the likely penalties incurred in seemingly unrelated areas.

Other potential obstacles, however, remain. A number of empirical, institutional, but also more fundamental conceptual difficulties might still have prevented the European countries from reaching welfare-enhancing outcomes. The following will consider three in particular:

i) The expectation that the benefits coming from policy coordination may be only small;

ii) The presence of domestic forces which may prevent international agreements being reached;

iii) The existence of fundamental disagreements between the potential partners on the correct use of instruments.

<u>Smallness of Effects</u>

An important impediment to international economic coordination is the widespread perception that, even if some measure of cooperation could actually be achieved, its eventual returns are likely to be rather small. At an impressionistic level, this view is corroborated by what are felt to be the failures of the major cooperative efforts of the 1970s - the Smithsonian Agreement collapsed within 15 months; the concerted reflation package agreed upon at the Bonn Summit is widely perceived as having generated only increased inflationary pressures.[3]

More rigorous analysis has come to less extreme conclusions, but the upshot of much recent work does indeed suggest that the gains from cooperation may be relatively small [Oudiz and Sachs, 1984]. Not only are they small in themselves, but they would seem to pale into insignificance if compared to the gains that can be achieved by chosing the right policies at home [Hughes Hallet, 1987]. In addition, many of the (small) gains are strongly model-dependent - if different, yet still reputable, models were a better representation of reality, then joint policies could almost as often generate losses for at least one, if not both, the cooperating partners [Frankel and Rockett, 1988].

Yet such scepticism about the economic efficacy of coordination is less appropriate in the case of Europe. Econometric estimates of the gains from coordination tend to suggest larger pay-offs for purely European efforts at concerted expansion than for similar OECD-wide exercises [Oudiz, 1986]. This is hardly surprising given the close economic links that tie the EEC countries together. Indeed, such econometric results may well underestimate the scope for gains from concerted reflation. The results are usually obtained from simulations carried out on existing multi-country models, such as those of the OECD or of the Japanese Economic Planning Agency (EPA). Such models, inevitably, incorporate the multiplier responses to domestic fiscal and monetary stimuli obtained on average in the past. Yet the past is likely to be a rather imperfect guide to future reactions in a world increasingly conscious of the international repercussions and constraints of any domestic reflationary package. European public opinion is almost certainly much more sceptical to-day than it was in the 1970s, let alone the 1960s, of the chances of success of a go-it-alone, Keynesian strategy, as amply demonstrated by the failure of the 1981-82 French "dash for growth".

It is highly likely, in these circumstances, that past multipliers may well <u>overestimate</u> the outcomes of domestic policy-led expansionary efforts, as the corporate world anticipates rapid depreciation, inflation and an inevitable reversal of the initial expansion. But, by the same token, the exisiting multipliers may <u>underestimate</u> the effects of a concerted reflation taken at the Community level. In such circumstances, the credibility of the package would be greatly enhanced, as private market participants would be much less fearful of the exchange rate or balance of payments consequences of domestic expansion. If there is any truth in this "Lucas' Critique" type argument, then the gains from policy coordination within Europe could indeed be sizeable.

<u>Domestic Opposition</u>

The standard theoretical picture of international co-operation assumes that countries are able to speak with one voice and then deliver their promised policy packages. In the real world, however, participants in international meetings, even when these are Summits, are often unable to fully commit themselves. Parliaments may not always ratify international agreements;

indipendent Central Banks may resist promises made on monetary policy; decentralized local authorities may not feel bound to respect fiscal pledges; bureaucracies may slow down the implementation of specific measures.

In addition, the presence of numerous domestic lobbies could interfere with international cooperation, since different costs and benefits will accrue to various interest groups. This is particularly true for fiscal policy whose effects (unlike those of monetary policy) can impinge in selective and pronounced ways on specific sectors or areas [Guerrieri and Padoan, 1988].

Such domestic obstacles to cooperation clearly exist. They would seem to be less serious, however, in most European countries than they are in, say, the United States where no President can fully commit Congress. Both France and Britain are highly centralized countries in which local economic autonomy is limited and Central Banks are broadly subservient to Finance Ministries. Italy is not too far from this model, even if the nature of coalition governments can restrict the freedom of the policy-maker negotiating in Brussels. It is really only in Germany that both Länder and Bundesbank autonomy can bind the hands of the negotiators.

Even this need not be necessary, however, since such national divisions can, at times (though, admittedly, not always) be exploited to further international economic cooperation. When some domestic groups favour a particular outcome, but others do not, foreign pressures can be used to tip the scales in one particular direction, as was apparently done by Chancellor

Schmidt at the time of the Bonn Summit [Putnam and Bayne, 1987]. And similarly, of course, private lobbies can be used to favour, just as much as to thwart, international agreements.

Different Views of the World

Much more serious obstacles come from potential disagreements between countries about policy impacts. Countries may legitimately differ on the size of the likely effects coming from particular measures. This might limit, but would not jeopardize, the scope for policy coordination. But if the differences extend to the sign of the expected effects, then dialogue is unlikely to be very fruitful. There is no point in trying to reach agreement on, say, tax cuts if one country believes that such cuts will be inflationary, while another expects them to be deflationary. This difficulty is compounded if what the economist considers an instrument becomes, for the policy-maker, an ultimate goal. An apt illustration of this comes from United States attitudes in the 1980s:

> "President Reagan does not think of taxes as an instrument of fiscal policy. Low taxes are in themselves his highest priority domestic objective on structural supply-side grounds ... To the U.S. Congress, spending programs are not fiscal policy instruments but ends in themselves" [Schultze, 1988, p.51].

Even in the European context, such differences in perceptions of "how the world works" are important. Different goals in the mid-1970s between those countries that gave priority to the fight against inflation (Germany), those that hoped to preserve reasonably high employment (Britain and Italy) and those which hovered in-between (France), clearly prevented any concerted strategy. It is only when inflation was seen to slow down in 1977-78 that a common position could be found again which led to the Bonn Summit. A similar common position was found in the early 1980s, when virtually all the European governments agreed on giving priority to an anti-inflationary strategy and the EMS was one of the instruments chosen in some countries for this purpose.

Little has, however, been done since then. The reasons for this lethargy can no longer be attributed to major differences in goals. Most EEC countries would nowadays diverge only in the weights they would assign to various aims. Since inflation has come down to very low levels, it could have been expected that policy-makers would have shifted their focus onto employment creation. Yet, in contrast to what happened in the later 1970s, there was no initiative whatsoever to try and tackle this problem collectively.

The main reason why this has not happened could lie in the very different attitudes, not to ultimate goals, but to intermediate instruments that have been held in Europe throughout the 1980s. While Central Bankers have tended to agree on the need for relatively prudent monetary policies, the same agreement was not forthcoming on how fiscal policies were to be used. The extraordinarily wide variety of views on how fiscal policies operate that characterized the decade was hardly conducive to reaching agreement on a concerted fiscal reflation.

III. ATTITUDES TO FISCAL POLICY

The 1980s saw a more or less concerted attack in most major OECD countries on "big government". In the name of monetary and fiscal convergence, of fiscal rectitude, or of supply-side economics, governments attempted to rein in public spending and reduce the size of budget deficits. But while these broad aims were generalized, the intellectual justifications provided for them diverged markedly across countries, as suggested by the following brief survey for the four major European economies.

United Kingdom

The first radical reinterpretation of how fiscal policy worked came from Britain's 1979 Conservative government. As elsewhere in the OECD area, the policy priority at the turn of the 1970s was the lowering of inflation and, as elsewhere, the conversion of policy-makers to a broadly monetarist position meant that control of the money supply was seen as a necessary (if not always sufficient) condition for the control of inflationary pressures. Where British policy parted company with monetarist orthodoxy, was in the simultaneous setting of what were seen as mutually consistent targets for fiscal and monetary policy, enshrined in the so-called "Medium Term Financial Strategy". Central to this policy framework was the belief that control of the money supply could only be achieved via control of the fiscal stance:

> "Fiscal policy is an important influence on monetary growth, and over the medium term control of the public sector borrowing requirement [PSBR] is necessary for effective control of the money stock"[H.M.Treasury, 1981, p.82].

An economist at the time close to government thinking expanded on the idea that the PSBR is closely linked to monetary growth:

> "The PSBR injects financial assets into the private sector's portfolio. These ... assets will have to be held in the form of bonds; in order to induce people to raise the proportion of bonds in their portfolios interest rates would have to rise. Every period that the PSBR maintains this higher level will be another period in which this process [of fresh rises in interest rates] is repeated ... This process cannot continue indefinitely, and so at some point the growth in the monetary base must rise to match the growth in bonds" [Minford, 1981, p.18].

In other words, it was argued that any increase in private sector wealth would lead to parallel increases in the demand for money so as to maintain portfolio balance between various financial assets. Such continuous shifts in the demand for money would, in turn, lead to ever increasing interest rates or else to rapid growth in the money supply. Whatever the expansionary effects of budget deficits in the short run, these would be wiped out, or even more than wiped out, by eventual declines in output resulting from excessively high interest rates or excessively rapid rates of inflation. In contrast to the Neo-Ricardian position, according to which bond-financed budget deficits have no effect on the economy, the PSBR was seen as being at the heart of the inflation problem.

The least that can be said is that this position found less than universal acceptance. Few monetarists subscribed to it. Laidler, for instance, was highly sceptical of the idea that "the adoption of monetary targets has any strong implications for the conduct of fiscal policy" [Laidler, 1981, p.162], while Friedman bluntly stated that "there is no necessary relation between the size of the PSBR and monetary growth" [Friedman, 1980, p.56]. Not surprisingly, perhaps, the closenness of the links between the PSBR and M3 (the money stock targeted by the British authorities) was found wanting at an econometric level [Hendry, 1981]. In addition, of course, the argument totally ignored the possibility that the original fiscal stimulus (by boosting activity and incomes) could actually diminish the size of the PSBR and ease its financing in the short run, thus obviating the need for higher interest rates or faster money growth.

Yet, despite these doubts and criticisms, the framework provided by the Medium Term Financial Strategy was strongly believed in as providing a theoretically consistent framework for winding down debt accumulation, monetary expansion and hence also inflation. British fiscal policy, once thought of as having powerful effects on the economy, had been relegated to a subsidiary role as an adjunct of monetary policy.

Germany

Though the control of public sector deficits figured as importantly in Germany's strategy after the Bonn Summit reflation as it did in Britain, the reasons given for this posture were very different from those provided by the United Kingdom Treasury. Indeed, the Bundesbank clearly stated its scepticism of the British position:

> "Longer-term [fiscal] plans are not systematically associated with corresponding monetary growth targets fixed by the Bundesbank; this would, indeed, hardly be possible" [Deutsche Bundesbank, 1981, p.293].

The German position was stated most clearly by the influential Sachverständigenrat (or Council of Economic Experts), whose views were also subscribed to by the Bundesbank and the Federal government. According to these views, recently restated by Professor Fels (a member of the Council in the early 1980s), budget deficits were counterproductive not so much because of their standard crowding-out effects, nor because they led to excessive monetary growth, but because of a subtler:

> "Psychological or expectations-induced crowding-out, according to which the rapidly growing government deficit and the accompanying current account deficit undermined international confidence in the mark: the inflationary impact of the depreciation absorbed much of any initial increase in private purchasing power, while the rise in interest rates necessary to halt the fall of the mark reduced private investment spending" [Fels and Froelich, 1987, p.181].

In addition, debt accumulation led to a loss of confidence among domestic investors fearful that the debt expropriations which Germany had twice experienced in living memory, might be repeated. As a result:

> "It is no longer possible to say that the overall effects of bond-financed expansionary measures are still positive. The opposite is more likely to be true" [Sachverständigenrat, 1982, p.121].

In contrast, the process of "fiscal consolidation" was thought to quickly overcome any direct negative effects on demand via positive indirect feedbacks on both consumers' and investors' confidence. A restrictive fiscal policy was thus felt to be both a necessary and a sufficient condition to raise investment: "the consolidation policy has done more to pave the way for the upswing in the German economy than to obstruct it" [Deutsche Bundesbank, 1986, p.20].

Little or no econometric evidence was mustered to support these propositions. Hardly any of the fiscal policy multipliers that can be gleaned from official models of the German economy suggest that these are negative.[4] And the indirect evidence adduced to show that fiscal retrenchment did indeed pave the way for a recovery of the German economy in the mid-1980s, failed to recognize the very important impact of buoyant United States demand.

Italy

Italian preoccupations with excessive public sector deficits seem more understandable, in view of the size of such deficits from the late 1970s onwards. These preoccupations, however, were primarily addressed not so much to the flow deficits themselves as to their stock consequences. It was the rapidly mounting volume of public sector debt that most worried the authorities.

In this instance, the channels of transmission were seen to run from continuing deficits, however financed, to eventual problems of instability in the economy. As was put in a very clear report by the Budget Commission of the Lower House:

> "The more worrying consequences of fiscal imbalances stem from their effects on continued debt accumulation ... When the ratio of public debt to total financial assets reaches very high values, the risk of sudden confidence crises increases; this can put a stop to further debt subscription and require sudden increases in money financing" [Camera dei deputati, 1985, pp.75-6].

Though some superficial similarity could be detected with the British position, the two were, nonetheless, very different. In the United Kingdom case, monetary financing was considered almost inevitable, whatever the level of the PSBR, in view of very rigid portfolio preferences. In the Italian case, this eventuality was only envisaged when the public debt/GDP ratio rose to some unsustainable figure. What such a figure might be was left unspecified, though the Bank of Italy expressed its worries in 1985 when the ratio (on the old national accounts data) had reached 99.6 per cent:

> "Neither other countries' experience nor economic theory provide indications as to the threshold value of debt accumulation beyond which perverse effects are felt in the real economy. There is no doubt, however, that high debt levels generate instability since they raise the sensitivity of the economic system to exogenous shocks" [Banca d'Italia, 1986, p.149].

It is clear that with a public debt/GDP ratio that approached unity, such fears were well founded, the more so as at the time the real interest rate was close to (or, at times, even above) the economy's real growth rate. Italy's position through most of the 1980s has been one in which the debt/GDP ratio was increasing continuously, generating a problem of dynamic instability. Hence, the need for an austere fiscal policy was probably most warranted in this case - even if, in practice, it was precisely Italy that least followed this prescription.

France

Among the four major European countries, France's need to curb its budget deficit was least pronounced. Both in the second half of the 1970s and in the first half of the 1980s, general government net borrowing was lower in France than in either Germany or the United Kingdom, let alone Italy.[5] Partly thanks to this, partly because "the economic policy of the government ... has not been the application of a doctrinal view of economics"

[Barre, 1980, p.516], the switch to a more restrictive fiscal policy that came with the "Plan Barre" of September 1976, was much less sharp than the later policy shifts of Britain or Germany. The major aim of the plan was inflation control and this was to be pursued by a multiplicity of instruments in view of the multiplicity of causes behind it.

In the words of the Prime Minister himself:

> "I have always repeated that inflation is the greatest threat to growth and employment and that France's future problems will not be solved by a continuous expansion of credit, artificially low interest rates, public sector deficits, regular and rapid wage increases, continuous growth in social security benefits and the slow but steady depreciation of the currency" [Barre, 1980, p.516].

Fiscal policy was clearly seen as only one element in the fight against inflation, together with money supply control, stability of the franc and wage moderation.

Under Barre, the aim was a return to balance. Under Mitterand, after the unfortunate reflationary episode of 1981-82, the aim became containment of the deficit at (or below) a level of 3 per cent of GDP, an aim reiterated annually in the INSEE reports on the economy [e.g. INSEE, 1984]. Both governments achieved their aims, Barre in 1980, Bérégovoy throughout the years 1983-87. Yet these successes were not obtained by a blind committment to predetermined goals. The fight against deficits was clearly not a function of dogmatic views, but a pragmatic response to a post-1973 world in which it was felt that France had to adapt to the prevailing orthodoxy. And this is reflected both by the flexibility with which fiscal retrenchment was applied,[6] and by the fact that it was, bar the 1981-82 episode, embraced by both right and left.

Implications

This brief summary suggests that behind the general themes of renouncing fine-tuning and of reducing budget deficits, very different views were held in some of the major European countries on the effectiveness of fiscal policies in the course of the 1980s.

Nor was this intellectual confusion limited to Europe. Both the United States and Japan paid lip service to similar aims, and both introduced yet further dimensions to the debate. In the United States, particularly during the first Reagan term, the Treasury firmly denied that the rapidly growing Federal budget deficit had had an impact either on interest rates or on the value of the dollar. As the Secretary to the Treasury, Regan, put it: "The idea that budget deficits cause interest rates to rise ... is not at all certain" [quoted in Marris, 1985b, p.182]. Japanese views were a good deal more orthodox and the standard crowding-out fears were expressed by the government [EPA, 1983]. The Japanese, however, added a further element to the panoply of criticisms of fiscal policy - in their view, too large a government sector, which their rapidly ageing population made almost certain, sapped an economy's "vitality" [EPA, 1981].

Basically, neither of the two traditional channels that may have hampered the workings of fiscal policies (difficulties in financing budget deficits, or the full employment of resources) figured prominently in the debate. Standard financial crowding-out mechanisms were seldom in the limelight. As for physical crowding-out, this cannot have been very prominent either, since most governments welcomed increases in aggregate demand so long as these came not from fiscal policy but from exports or private investment. In essence, what was in place, in several if not all the major OECD countries, was a strong ideological commitment to retrench the role of government and shrink the size of the welfare state, justified with a motley of dubious theories, hardly supported by empirical evidence.[7]

In the circumstances, hoping for concerted reflationary action in Europe, led by fiscal instruments, was clearly unrealistic. Some countries viewed such instruments as ends in themselves; others viewed them as being totally ineffective, or indeed as having a perverse impact on the ultimate employment and output variables. This is particularly true of the two countries whose room for manoeuvre was the greatest from the early 1980s onwards - Germany and Britain. Neither suffered from balance of payments constraints through most of the period and both had taken drastic, and broadly successful, steps to diminish their public sector deficits and the rate of inflation. French and Italian positions were more mainstream, and both countries would probably have welcomed some modest dose of joint reflation. But both countries were in a much weaker position, France because of the perceived failure of its 1981-82 fiscal expansion, Italy because of its clear need to control a burgeoning deficit and runaway debt accumulation.

CONCLUSIONS

International macroeconomic policy coordination is a demanding task which has only seldom been attempted in the past, be this in Europe or in the OECD area [Boltho, 1988]. Though the EEC has a long history of cooperation, this has been largely microeconomic in nature and based on a framework of rules. More recently, the Community has embraced macroeconomic cooperation in the monetary area, but here too the preference has been for a rules-based regime, together with some collective discretion. So far at least, the EEC countries have shied away from pooling their macroeconomic policies, even in circumstances, such as the 1980s, when a common and very serious unemployment problem might have given the impetus for a concerted reflationary strategy. Indeed, if anything, they seem to have been more willing to coordinate policies with the United States, as shown by experience in the 1960s and 1970s, than among themselves.

A number of reasons may explain the 1980s reluctance, only some of which have been explored in this paper. One argument, hardly mentioned so far, that could have militated against discretionary fiscal expansion, would have been the perception that Europe's natural rate of unemployment had risen *pari passu* with the actual rate. Yet, this thesis can hardly be defended. After all, both the German and the British governments, which were at the forefront in arguing that labour markets had become extremely rigid, at the same time welcomed increases in private demand or in exports. As for France and Italy, neither country felt that it was really close to full employnment.

Much more important were incompatible views of how fiscal policies worked. For Britain and Germany the issue was simple. If for different reasons and through different mechanisms, they both felt that such policies were ineffective or indeed counter-productive. Italian governments never held such extreme views, but were legitimately concerned with the longer-run consequences of debt accumulation. That left only France clinging to a more mainstream position, but one hampered by its failed attempt at expanding in isolation, and hence strongly committed to reacquire credibility in its fight against inflation.

At a more political level, absence of a concerted approach may have been due to a lack of leadership, possibly "an essential condition for effective coordination" [Artis and Ostry, 1986, p.73]. At the OECD level:

> "History teaches us that it is only when the United States become convinced that there is something wrong with the international economic system that things actually begin to happen" [Marris, 1985a, p.383].

At the European level, this statement could be applied to Germany. Leadership is hardly exercised by the EEC Commission and must come from either the French-German axis or from Germany alone. In the 1980s, Germany either did not see anything wrong with what was happening, or else felt that the Keynesian policies implicit in any coordinated reflation were clearly inappropriate.

It could be argued that this picture may be changing as Europe approaches the 1990s. There is, firstly, a greater recognition that expansionary fiscal policies may, after all, have beneficial effects. The clearest example comes from Japan, where a large increase in public investment has had a perceptibly favourable impact on output in 1987-88, and little effect on the budget deficit [OECD, 1988a]. Britain and Germany have also experimented with fiscal relaxation with, on the whole, positive outcomes. In Britain, behind the smokescreen provided by public asset sales, cyclically adjusted budget deficits suggest a clear move towards expansion between 1982 and 1986 [Price and Muller, 1984; OECD, 1987]. It is difficult not to think that the boom in which Britain has found itself since the mid-1980s is unrelated to this change in policy. The German conversion is both more recent and more modest, but the 1985-88 relaxation in fiscal policy is seen, at least outside Germany, as having had some favourable impact on activity [OECD, 1988b].

In addition, though inflationary fears have re-emerged in early 1989 (particularly in the United Kingdom), in most European countries the more pressing problem is still that of unemployment. Both these trends together would seem to militate in favour of greater attempts to devise common strategies. France and Italy would certainly welcome them, and even Britain, saddled with a high and rapidly growing external deficit might lend them a more sympathetic ear.

Yet, it is difficult to see the European countries moving towards more concerted fiscal policies except, at best, at discrete and infrequent intervals. Germany, which has on some occasions expressed misgivings about its membership of the EMS, is even more hostile to discretionary policy coordination. Moreover, the EMS, let alone the longer-run prospect of greater monetary union, have limited, and will increasingly limit, the freedom of monetary policy, while the harmonization of tax rules will diminish fiscal independence. In such circumstances, countries will wish to maintain as much domestic control as possible on those fiscal policy instruments that remain in their hands.

It is true that, as a consequence of 1993, demands for an EEC-wide fiscal policy will increase. Such demands, however, would presumably be primarily for a distributive rather than for a macroeconomic function. The upshot of all this suggests that in the next decade, the EEC will continue to strengthen, at the supranational level, rule-based cooperation, be this in the field of exchange rate stability or income redistribution between regions. Discretionary macroeconomic coordination will, as in the past, remain very much the exception rather than the rule.

FOOTNOTES

* The paper has benefited from comments by Chris Allsopp, Wendy Carlin and Loukas Tsoukalis who, as customary, are excused from all blemish.

1. These have come, in particular, from a string of reports published by the influential macroeconomic group set up at the Centre for European Policy Studies [see, for instance the latest: Drèze et al., 1987], and have even been endorsed by the much more cautious Commission [Commission of the European Communities, 1985].

2. Admittedly, however, Germany intervened vis-à-vis the dollar.

3. This seems to be an almost universally held view. But this judgement ignores the potential inflationary effects which were coming from massive Bundesbank and Bank of Japan interventions to prop up the dollar and the upward shift given to prices and inflationary expectations by OPEC 2. Indeed, the acceleration in the growth of consumers prices which Germany and Japan recorded between 1978 and 1981, gives way to stability or deceleration if the focus is on domestically generated inflation, as proxied by the GDP deflator.

4. Thus, fiscal policy multipliers remain positive, under a variety of assumptions, after 3 or 5 years respectively, in the multi-country models of the Japanese Economic Planning Agency and the OECD [EPA, 1987; Richardson, 1987]. It is true that a negative multiplier can be found in the Bundesbank's model, but it becomes negative only after 7 years from the original policy change [Chan-Lee and Kato, 1984].

5. Between 1974 and 1985, France's budget deficit was, on average, equal to 1.5 per cent of GDP, as against figures of 2.8 per cent in Germany, 3.7 per cent in Britain and 10.1 per cent in Italy (as well as 2.3 per cent in the United States and 3.2 per cent in Japan).

6. In 1977, for instance, policy was relaxed because of a weakening in activity; in 1981 it turned expansionary, before the change in government, partly because of electoral considerations.

7. Indeed, the divergences went beyond perceptions and also encompassed the choice of indicators. In Britain and Italy, policies stressed the broadest measure of public sector borrowing; in Germany and the United States the focus was on the Federal government's deficit; in Japan, attention was limited to an even narrower concept (the so-called "general account" of the central government's budget), while France shifted between general and central government concepts.

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