Adjusting to EMU: the impact of supranational monetary policy on domestic fiscal and wage-setting institutions

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Adjusting to EMU

The Impact of Supranational Monetary Policy on Domestic Fiscal and Wage-Setting Institutions

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ABSTRACT

The article suggests an explanation for seemingly diverse patterns of change in domestic economic institutions following the establishment of Economic and Monetary Union (EMU). It argues that EMU participants redesigned ill-fitting domestic fiscal and wage-setting institutions in order to counter the anticipated destabilizing effects of the 'one size fits all' monetary policy of the European Central Bank (ECB). After outlining the argument, the article identifies general economic and institutional conditions that are required for the use of fiscal and wage-setting institutions as effective stabilizers in a monetary union. It then undertakes a comparative assessment to detect country-specific mismatches between anticipated needs and the available domestic economic institutions. Finally, the article surveys institutional changes in 10 member states between the mid 1990s and 2002 and shows that the observed institutional adjustments largely correspond to the expected correction of initial mismatches.

KEY WORDS

- Economic and Monetary Union
- economic policies
- fiscal policy-making
- wage-setting

Introduction

The question of how Economic and Monetary Union (EMU) affects policy-making institutions in member states is certainly not new in the literature. Especially during the early years of EMU, a number of analyses sought to use the implications of the comparative assessment of the interplay between different policy orientations of central banks and different organizational structures of wage-setting to draw relevant conclusions for EMU (mainly Hall and Franzese, 1998; Iversen, 1998; Iversen, 1999b; Soskice and Iversen, 1998). Although this literature made significant achievements in the understanding of the interplay between the single monetary policy and domestic economic policy-making within a framework of long-term factors, it put little emphasis on cyclical phenomena. This paper takes a different approach. Since the European Central Bank (ECB) does not take into account economic developments in single member states but rather targets the euro area as a whole, its monetary policy is likely to result in significant short-term deviations around the long-term trend generated by suboptimal real interest rates. As soon as the two main factors underlying the appropriate conduct of monetary policy – the inflation rate and the output gap (see Taylor, 1993) – significantly deviate from the euro area average, monetary policy has adverse and, in the medium term, even self-enforcing pro-cyclical effects. When European Union (EU) member states decided to join EMU, they had to anticipate this risk.

The main mechanism driving such self-enforcing cycles in a monetary union is the country-specific real interest rate. Member states with inflation rates higher than the union average will face low real interest rates, triggering higher rates of investment and consumption. These effects will drive up the domestic growth rate beyond its long-term potential, leading to even higher inflation rates, further reducing real interest rates and ultimately resulting in cyclical overshooting and price bubbles. Similarly, in a context of low inflation and high real interest rates, growth rates are likely to fall below potential growth, thus triggering even higher real interest rates and potentially generating a textbook bust cycle.

The only mechanical way (i.e. not policy induced) to stop such self-enforcing real interest cycles is the real exchange rate effect: high-inflation countries will ultimately face reduced external demand, whereas low-inflation countries will improve their competitiveness. As a consequence, self-enforcing cyclical phenomena will be stopped by a decline (or boom) in exports caused by the real appreciation (depreciation) of the exchange rate. Prior to the start of EMU, most theoretical analyses of monetary unions assumed that the real exchange rate effect would have primacy over the real interest effect and that domestic stabilization would therefore be generated automatically (see mainly Frankel and Rose, 1998). This approach was built on the assumption that domestic prices (and thus also real interest rates) in a monetary union are bound to converge, given the mobility of goods and services in the internal market. In EMU, however, a significant share of domestic output derives from so-called 'spatially fixed factors', such as real estate and heavy machinery, which are not affected by direct price competition (Maclennan et al., 1998). Moreover, as analyses of the much more integrated US states indicate, regional economic adjustments based on real exchange differentials take a significant amount of time (around four years; see Arnold and Kool, 2002), indicating that adjustment within the EU might take even longer (see IMF, 2004, for first evidence in that respect).

The article suggests that, depending on the expected output gap and inflation deviations from the euro area average, member countries designed institutions that would allow the correction of a domestic boom or recession. This argument obviously raises the question of domestic policy-makers' motivations to design appropriate institutions. Scholars convinced by the patterns of the political business cycle might readily agree that correction of domestic bust cycles ranks high on the political agenda, yet they would probably cast doubt on the assumed policy goal of correcting an inflationary high-growth bubble. Although such doubts are certainly valid, they do not bring into question the overall argument of this paper. Putting appropriate institutions at the disposal of policy-making is the necessary condition for their application, but it leaves policy-makers the choice of whether or not to use them. The article thus expects to detect institutional adjustments in those areas in which the properties of the relevant institutions in the *status quo ante* (i.e. before joining EMU) could not be considered instrumental in delivering appropriate policy responses to the anticipated destabilizing economic effects of EMU. Although this argument is used to explain institutional change as a reaction to EMU, it could in principle also be applied more widely to any fully credible fixed exchange rate regime. What is so specific about EMU, however, is the degree of credibility. It is possible to correct a fixed exchange rate and even to drop out of a currency board, as Argentina did in 2002, but not to alter the conversion rates in a monetary union. Moreover, even in a fully functional fixed exchange rate regime, there can (and, from an economic perspective, mostly should) be different nominal interest rates.

The full need for appropriate domestic institutions to cope with the absence of monetary policy thus only arises if a currency peg is fully credible – institutional reforms in the Netherlands in 1982 fit the framework suggested in this paper, see below – or in a monetary union (the adoption of a foreign currency as legal tender in a domestic economy, often quite wrongly labelled 'dollarization', no matter which currency is chosen, would have similar effects). The formal transition from the European Monetary System to EMU thus represents a clear regime shift. Yet the timing of that shift is of a subtle nature: what matters most is the point at which the credible decision to adopt a hard peg (and to stick to it for good) was taken. The penultimate section of the article reports individual starting dates of de facto accession to EMU for each member state.

The article is organized as follows. We outline the main arguments, and review the institutional *status quo ante* in 10 EMU member states. The nature of the cyclical imbalances that EMU member states had to anticipate before joining EMU are then studied. Institutional adjustments between the mid 1990s and 2000 in 10 EMU member countries are reviewed, showing that the expected patterns of adjustment can actually be observed, before the article's conclusion.

Institutions and cyclical stabilization

In the absence of domestic monetary policy, fiscal policy and wage-setting can stabilize economic cycles under certain institutional conditions.

In a boom, wage-setting and fiscal policy need to act jointly if they wish to cool down the economy. Wage-setters have to accept wage increases below the often claimed rule of a productivity increase plus expected inflation in order to discount the inflationary effect of economic growth rates above potential. A contractionary fiscal policy needs to accompany real-wage restraint in order to prevent firms from exploiting lower wage costs to boost production even further. Naturally, such a mix between countercyclical wage-setting and contractionary fiscal policy can succeed only if governments do not redirect the additional resources to the production cycle but rather keep them as a surplus or as a significantly reduced deficit (in a system of fiscal redistribution, a surplus from high-growth regions would go to regions with lower growth). It should be added that fiscal policy alone is likely to fail in an attempt to cool down the economy. A contractionary fiscal stance is likely to be followed by higher wage claims, thus triggering a pro-cyclical wage policy. In short, the correction of a boom cycle requires fairly close cooperation between fiscal policy and wage negotiators.

In a bust cycle, wage-setting is of little use as a short-term stabilizing instrument. Wage-setting cannot provide an effective response either. Although wage restraint can ultimately restore growth through gains in competitiveness, in the short run it depresses domestic demand (mainly consumption) even further. Real-wage increases are not a good response either: they would even further reduce firms' profits and depress domestic investment. Fiscal policy, on the other hand, can have a stabilizing effect. Though economists are generally sceptical about fiscal stimuli, they do not dispute their economic effectiveness; rather they are worried about political implementation. They argue that deficit spending fails if consumers take into account later tax increases (e.g. Lucas, 1996), that wages and prices in EMU member states are too rigid to allow for balancing adjustments (e.g. Layard et al., 1991), and that political implementation is difficult owing to time-lags at both the domestic (e.g. Krugman, 2000) and the EMU levels (e.g. Sala-i-Martin and Sachs, 1992; Artis and Winkler, 1998). Effective fiscal stabilization in a downturn is thus mainly hampered by institutional parameters (wage rigidity and fiscal institutions) that can – at least theoretically – be resolved through institutional change.

Table 1 summarizes how domestic economic policies can stabilize the domestic business cycle in a monetary union.

With regard to the implementation of the appropriate stabilization policies, however, certain institutional features are required.

Fiscal policy

As discussed above, fiscal policy can theoretically intervene as a cyclical stabilizer in both a boom and a downturn if the fiscal authorities can react in a timely and decisive enough manner to yield the desired effect. Such a reaction is possible only if the budgetary authority can adjust swiftly to unforeseen circumstances and can push through a policy stance that is economically required as a stabilizing measure. However, not all types of fiscal institutions are similarly capable of producing desired policy outcomes (von Hagen, 1992; von Hagen and Harden, 1995; von Hagen and Hallerberg, 1997; Hallerberg and von Hagen, 1999, see also de Haan et al., 1999). The central arguments of this literature relate to the risk of an ineffective fiscal policy outcome if the budgetary process is not dominated by one key actor defending the overarching objective of fiscal policy ('logic of delegation'), or if such an overarching objective is not fixed *ex ante* in a contract binding for all

Table 1 Possible adjustment policies in EMU

	Fiscal policy	*Wage-setting*
Boom cycle	Can stabilize but needs to act jointly with wage-setting	Can stabilize but needs to act jointly with fiscal policy
Bust cycle	Can stabilize	Cannot stabilize

Table 2 Fiscal institutions, 1990

	Political strength				*Fiscal centralization*			
	Negotiations within government	*Parliamentary stage*	*Transparency*	*Flexibility*	*Centralization*	*Public sector share in GDP*	*Total political strength*	*Total centralization*
Austria	4.00	4.00	15.00	16.66	35.46	52.61	39.66 (0.06)	18.66 (0.35)
Belgium	1.00	4.00	10.00	11.20	66.32	53.13	26.20 (1.04)	35.24 (–1.58)
Denmark	12.33	12.00	13.33	10.40	30.59	29.03	48.06 (–0.55)	8.88 (1.49)
Finland	5.00	6.00	17.00	13.00	29.32	55.06	41.00 (–0.04)	16.14 (0.64)
France	16.00	18.00	14.66	20.20	55.19	53.66	68.86 (–2.06)	29.61 (–0.92)
Germany	12.00	4.00	17.00	18.60	16.84	48.12	51.60 (–0.81)	8.10 (1.58)
Ireland	3.00	8.00	5.00	11.00	50.07	36.45	27.00 (0.98)	18.25 (0.40)
Italy	7.66	6.00	5.00	1.00	54.28	51.76	19.66 (1.52)	28.10 (–0.75)
Netherlands	10.66	16.00	18.00	5.00	45.91	47.74	49.66 (–0.67)	21.92 (–0.03)
Portugal	9.66	5.00	7.33	14.00	80.31	44.48	35.99 (0.33)	35.72 (–1.64)
Spain	6.00	4.00	17.00	5.80	39.64	42.49	32.80 (0.56)	16.84 (0.56)
Sweden	5.33	8.00	9.00	5.33	27.28	62.72	27.66 (0.93)	17.11 (0.53)
UK	15.00	16.00	16.00	11.40	61.21	44.41	58.40 (–1.30)	27.18 (–0.64)

Sources: Von Hagen (1992) quoted in Hallerberg (2004) for columns 1–4 on political strength; own calculations based on data from *OECD Economic Outlook* for columns 5–6 (following Scharpf, 1991). Figures in parentheses are *z*-values.

participants in the budgetary process ('logic of commitment'). Originally, this body of literature focused on the effectiveness of fiscal policy in reducing public debt and budgetary deficits. However, it can also be applied to the context of this paper, given that the logic of delegation (henceforth referred to with the more general term of 'government effectiveness') nicely captures a key requirement for fiscal stabilization in EMU, which is that stabilizing measures need to be implemented in a rapid and decisive manner.

That said, even if stabilizing measures can be implemented, they are not necessarily effective in economic terms. Countries with a very large share of public expenditure can more easily use fiscal policy to influence the economic cycle. Subnational authorities might have a large share in total public expenditures but are generally not willing to contribute to nation-wide goals of economic policies (Scharpf, 1991; Hughes and Smith, 1991). The probability of effective stabilization thus tends to increase with the share of the central governments' expenditures in total public expenditures, i.e. with fiscal centralization.

Both variables described in this section (the effectiveness of the budgetary process and fiscal centralization) can be easily operationalized. The effectiveness of the budgetary procedure is mapped using data by von Hagen for the year 1992 on the logic of delegation in the budgetary process.[1] Von Hagen looks at four components of the effectiveness of the budgetary procedure: the structure of negotiations within government; the involvement of parliament; the transparency of the budget draft; and the flexibility of budget execution (see Table 2). Following Scharpf (1991), fiscal centralization is measured as the centralization of fiscal spending (the share of the central government in total public spending) and the government spending ratio (total government spending as a share of GDP).

Putting together the results of these two types of country classification, Table 3 gives an overview of fiscal institutions in EMU in the *status quo ante* (i.e. in 1990). Only countries in the north-west cell could rely on fiscal institutions capable of successfully correcting cyclical imbalances before joining EMU. However, as pointed out above, in the special circumstances of cyclical overheating, fiscal institutions cannot act alone, but require support by wage-setting.

Wage-setting

For the purpose of this article, it is important to identify the institutional conditions under which wage-setters are capable of taking the requirements of cyclical stabilization (i.e. real-wage restraint) into account. As the 'corporatist' literature has argued, only coordinated and centralized wage-setting

Table 3 The *status quo ante* in fiscal institutions, 1990

		Centralization High	**Centralization** Low
Government effectiveness	High	France UK Netherlands	Denmark Germany Finland Austria
	Low	Belgium Portugal Italy Ireland	Sweden Spain

Sources: Table 2.

systems are capable of influencing concretely defined target rates of wage variation at the aggregate level (e.g. Schmitter and Lehmbruch, 1979; Streeck and Schmitter, 1985).[2] Indeed, in a fully decentralized system, a cyclical boom would trigger no incentive for the individual wage-setter to accept real-wage restraints, because there is no guarantee that other wage-setters would adopt the same behaviour.[3] To overcome this collective action problem, concretely defined target rates need to be set and adhered to. It follows that real-wage restraint can succeed only in a system with a wage-setting authority capable of detecting *ex ante* and enforcing *ex post* the rate of wage variation required for cyclical stabilization. Moreover, there has to be some dialogue between wage-setters and government to allow coordinated stabilization.

The presence of an instance of internal leadership is well captured in an indicator of the Golden, Wallerstein and Lange (GWL) index on the role of union federations in wage negotiations (labelled CONIN in the GWL data set) (Golden et al., 2002). What this indicator does not capture, however, is the special role of 'pattern-bargaining systems'. Such systems are characterized by semi-centralization, with a significant amount of horizontal coordination across unions (Traxler and Kittel, 2000). One union plays the role of a leading wage-setter, whose agreements are generally followed by the other unions – Germany and Austria fall into this category (Traxler et al., 2001). Pattern-bargaining systems were thus added to the GWL indicator as scoring 'high' with regard to internal leadership. Table 4 provides an overview of the resulting wage-setting systems prior to EMU.[4] The second institutional characteristic relates to the link between wage-setters and the government. The GWL data set contains a variable that precisely indicates governments' involvement (GOVIN).[5] On the basis of Table 4, the *status quo ante* in wage-setting can be established (Table 5).

Table 4 Wage-setting institutions, 1990

	Internal leadership CONIN		*Government involvement* GOVIN	
Austria	3 (pattern)	High	6	High
Belgium	4	Low	4	Low
Denmark	1	Low	5	High
Finland	9	High	9	High
France	4	Low	3	Low
Germany	1 (pattern)	High	3	Low
Ireland	3[a]	Low	–	High
Italy	1	Low	8	Low[b]
Netherlands	9	High	6	High
Portugal	1[a]	Low	–	Low
Spain	3	Low	3	Low
Sweden	9	High	5	High
UK	1	Low	2	Low

Sources: Golden et al. (2002: variables CONIN and GOVIN). Ireland, Portugal and Spain are classified on the basis of Traxler et al. (2001: 114).
[a] Own classification based on the approach in Golden et al. (2002).
[b] The classification for Italy was modified from high to low (for reasons see main text).

Table 5 The *status quo ante* in wage-setting institutions, 1990

		Government involvement High	**Government involvement** Low
Internal leadership	High	Finland Netherlands Austria Sweden	Germany
Internal leadership	Low	Denmark Ireland	Belgium France UK Italy Portugal Spain

Source: Table 4.

Putting together the information on fiscal institutions and wage-setting institutions, it becomes clear that only one EMU member state completely fulfilled the institutional prerequisites of domestic stabilization before joining EMU: the Netherlands. The special status of the Netherlands is not really surprising – and to a certain extent even confirms the approach chosen in this paper – since the Netherlands had been a member of a de facto currency union with Germany since 1979. Without going into too much detail, it is interesting to note that, right after the Dutch decision to reproduce German monetary policy almost fully in the Netherlands (there was only one devaluation of 2% in 1983), the wage-setting system completely changed (the Wassenaar agreement in 1982). For all other countries, the *status quo ante* indicates that reforms were necessary to prepare for joining EMU. Table 6 lists the missing features.

Before considering the actual reforms implemented in EMU member states since the early 1990s, it is necessary to look at the expected adjustment pressures. This is because of the differing institutional requirements, depending on the type of adjustment pressure (boom or bust).

Assessing the expected economic pressures from EMU

Two factors need to be taken into account when assessing the anticipated economic pressure on EMU members: (i) their output gap in relation to the euro area output gap; (ii) their inflation rate in relation to the euro area inflation rate (Taylor, 1993). I assume that no EMU member state – not even Germany – could anticipate that the monetary policy of the ECB would actually fit its domestic economic requirements. None of the present 12 euro area member states represents more than one-third of euro area GDP, and current analyses of the ECB's policy confirm that decisions are based on developments in the euro area as a whole (IMF, 2004; Surico, 2003a,b).

Table 6 Institutional preparedness for joining EMU (*status quo ante* in 1990)

		Fiscal policy		*Wage-setting*
Austria	–	Centralization missing	++	Both features available
Belgium	–	Political strength missing	– –	Both features missing
Denmark	–	Centralization missing	–	Internal leadership missing
Germany	–	Centralization missing	–	Government involvement missing
Finland	–	Centralization missing	++	Both features available
France	++	Both features available	– –	Both features missing
Ireland	–	Political strength missing	–	Internal leadership missing
Italy	–	Political strength missing	– –	Both features missing
Netherlands	++	Both features available	++	Both features available
Portugal	–	Political strength missing	– –	Both features missing
Spain	– –	Both features missing	– –	Both features missing
Sweden	– –	Both features missing	–	Internal leadership missing
UK	++	Both features available	– –	Both features missing

Figure 1 maps the correlation and average deviation of business cycles (i.e. the output gap) for the period 1982–95. Greater distances from 0 on both axes indicate an overall stronger tendency to deviate from euro area output gap data. The more important indicator is on the area axis: countries with positive values on this axis are likely to expect higher growth momentum (mainly Spain, Ireland and the Netherlands). Finland's data are somewhat distorted by the exceptionally pronounced recession of early 1990.

For the relation of the domestic inflation rate to the euro area inflation rate, a different time-period was chosen (1989–99). The reason relates to the anti-inflationary policies that European central banks started to adopt at different points during the 1980s. The period 1982–8 would distort the data unnecessarily and would yield largely irrelevant results for this study. The period 1989–99 offers a compromise between a reasonable starting point and an acceptable number of years.

Figure 2 shows that deviations generally remain within a 1% margin. Although this can certainly be considered a rather satisfactory result, one should take into account that 1 percentage point is the equivalent of 100 basis points in terms of the real interest rate. What is of considerable importance,

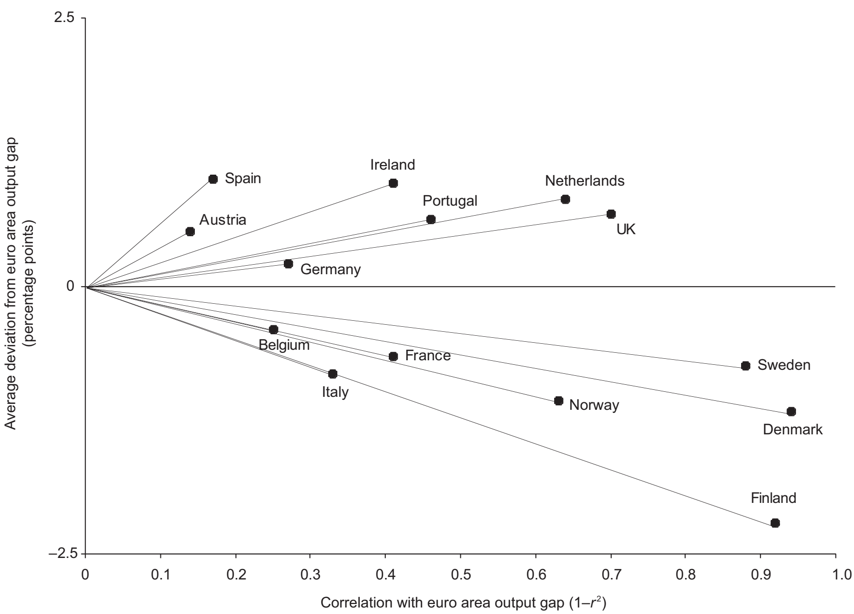

Figure 1 Domestic output gap and euro area output gap, 1982–1995.
Source: Own calculations based on data from *OECD Economic Outlook*.
Note: Deviations from the output gap have been inverted: a higher numerical value implies average deviations above potential (i.e. inflationary pressure).

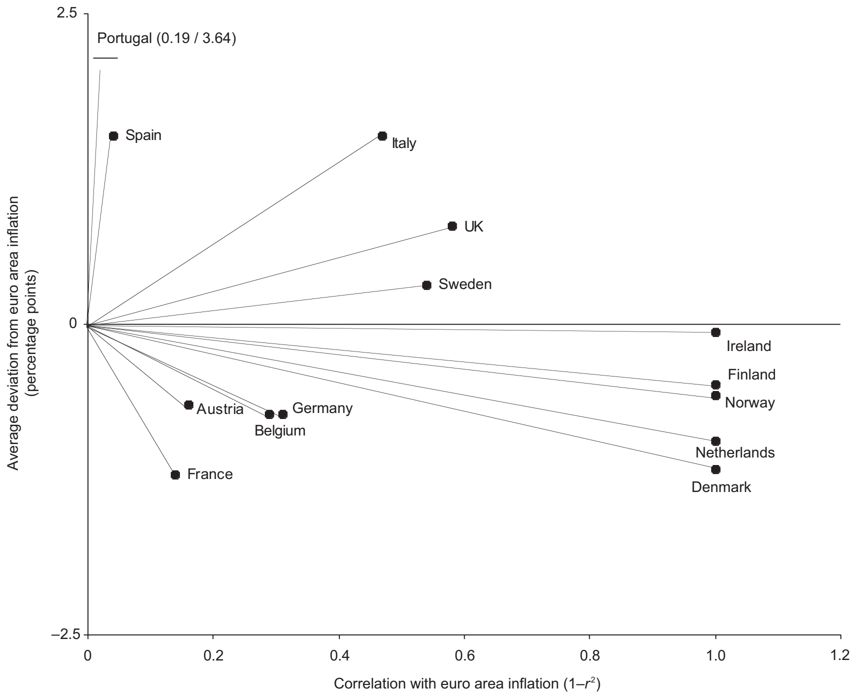

Figure 2 Domestic inflation and euro area inflation, 1989–99.
Source: Own calculations based on data from *OECD Economic Outlook*.

however, is the fact that a few countries stand out as clearly 'high inflationary', namely Portugal, Spain and Italy. With regard to the correlation values, it is remarkable how little synchronization can be detected.

The economic pressures to adjust to EMU can now be put together in a way that allows us to assess how member states were likely to perceive their own position, i.e. which kind of economic pressure they had to anticipate under a *ceteris paribus* assumption (Table 7). There are three groups of countries:

- Countries in the first group (Austria, Belgium, France and Germany) were likely to face high real rates and thus a cyclical downturn. These countries could be expected to adjust fiscal institutions only.
- Countries in the second group (Ireland, Portugal and Spain) had to expect very low real rates and thus a cyclical boom. These countries could be expected to adjust both fiscal and wage-setting institutions and see the emergence of close links between wage-setters and government.

Table 7 Anticipated economic pressures in EMU

	Inflation deviation prior to EMU	*Output gap deviation prior to EMU*	*Anticipated effect of ECB monetary policy (ceteris paribus)*	*Average inflation deviation from EMU aggregate inflation (1999–2003)*
France	Lower than EMU	Lower than EMU	High real interest rates	–0.5
Germany	Lower than EMU	Average	High real interest rates	–0.6
Austria	Lower than EMU	Higher than EMU	High real interest rates	–0.4
Belgium	Lower than EMU	Lower than EMU	High real interest rates	–0.1
Spain	Higher than EMU	Higher than EMU	Low real interest rates	+1.2
Portugal	Higher than EMU	Higher than EMU	Low real interest rates	+1.2
Ireland	Average	Higher than EMU	Low real interest rates	+2.1
Italy	Higher than EMU	Lower than EMU	?	+0.3
Finland	Lower than EMU	Lower than EMU	?	+0.2
Netherlands	Lower than EMU	Higher than EMU	?	+1.3

Sources: Own indicators; inflation data from Eurostat.

- A third group comprises countries that do not easily fit into one of the two groups. The data for Italy, Finland and the Netherlands do not give sufficiently clear indications of the expected adjustment pressures.

The actual reforms: An overview

This section summarizes the actual reforms of fiscal policy institutions and wage-setting institutions between the mid 1990s and 2001. It describes institutional changes (or lack thereof) in those areas that were identified as representing a misfit with regard to the specific policy challenge. It would have been beyond the scope of this article to test systematically for alternative explanations. This section uses short descriptions of how reforms were implemented to underscore the link to EMU. A more encompassing assessment of the reforms and their underlying explanations can be found in Enderlein (2004a).

It is quite striking that most EMU members actually aimed at creating the necessary institutions for domestic stabilization. As the overview indicates, they sometimes chose intermediate or innovative ways to overcome actual institutional constraints. In fiscal policy, there was a general trend towards more political strength in the budgetary process (Hallerberg et al., 2001; see also Hallerberg 2004). Fiscal policies also became more centralized – mainly within the framework of 'domestic stability pacts' that gave central governments more influence over subnational spending. In wage-setting, there was a pattern of more coordinated approaches combined with stronger government influence, often taking place within the framework of social pacts (Hancké and Rhodes, 2005; Hancké and Soskice, 2003; and Hassel, 2003). Such pacts usually require, and sometimes even create, some internal leadership within the wage-setting system, while also establishing a direct link with government.

Table 8 summarizes the results and indicates that the actual reforms largely confirm the expectations of the approach.

Institutional adjustment in countries facing high real interest rates

For Austria, Belgium, France and Germany, high real interest rates and low growth rates could be predicted as potential economic effects of EMU. These countries therefore had to rely on fiscal policy as a stabilizing instrument. Before joining EMU, three out of the four countries did not have appropriate fiscal institutions. Only France's institutions fulfilled the two required criteria (centralization and budgetary effectiveness). Austria and Belgium implemented the predicted reforms, whereas Germany did not.

Austria joined a de facto monetary union with Germany in the early 1980s but, given the high structural similarities between both economies, Austria did not experience any destabilizing effect from that union – unlike Belgium and the Netherlands (see below) (OECD, 1998a: 3). Taking into account that in EMU the ECB would target not Germany but the euro area average as a whole, Austria had to anticipate domestic destabilization from 1999 onwards. Austria was expected to centralize fiscal spending or at least to enhance control over subnational spending. The latter was implemented. In 2000, the central government imposed a 'Pact for reaching a deficit of 0 percent' upon regional governments and local governments. Although the title alludes to the Stability and Growth Pact in Europe, its contents clearly increase the authority of the central government over subnational spending: subnational governments and local governments have to achieve budgetary balances of 0.75% and 0%, respectively, and, in exchange, are given a guarantee of fiscal support from central government in periods of cyclical downturns (Hallerberg et al., 2001: 18). The underlying logic and implementation of this measure fully correspond to the hypothesis of this article (see also Enderlein, 2001).

Belgium joined a de facto monetary union with Germany in March 1992, when the Belgian National Bank (BNB) announced that it would not accept further devaluations vis-à-vis the D-Mark and closely follow the monetary policy of the Bundesbank without taking into account any potential destabilizing effects.[6] Belgium was expected to increase the effectiveness of the budgetary procedure and did so from 1994 onwards. The Belgian government authorized the Conseil supérieur des finances (CSF), which had been a simple advisory body to the ministry of finance, to set a binding budgetary balance before the negotiations on the budget among ministers actually started. The CSF has thus become the main player in Belgian macroeconomic policymaking, largely controlling the impact of the Belgian budget on the economic cycle. What is remarkable in this respect is the involvement of the BNB in the CSF. As Hallerberg (2000) argues, the three representatives of the BNB play a key role in the CSF and de facto set the net balance of the Belgian budget.

Germany clearly set the monetary policy stance for the European monetary system (EMS) until 1999, but had to expect a destabilizing policy by the ECB thereafter (this expectation is now widely confirmed; see IMF, 2004, for evidence). Germany was expected to centralize fiscal spending or at least to enhance control of subnational spending. In accordance with the framework of this paper, an attempt to implement a domestic stability pact was made in 2003. Yet this attempt largely failed (see Bundesbank, 2005, for a detailed discussion of the matter). Although this conclusion formally contradicts the approach of this paper, a few additional remarks may indicate why the failure of that reform does not necessarily stand in contrast to its suggestions. First, there was less awareness of the potential destabilizing effects resulting from EMU in the German government. Indeed, before the start of stage three of EMU, most German officials assumed that the ECB would take German economic conditions very strongly into account – or even fully target the German economy. This, however, did not happen, and Germany has had to struggle with real interest rates at a much higher level than has been appropriate for the German economy. In September 2001, officials in the German ministry of finance confirmed in interviews for this study that they had underestimated the destabilizing impact on Germany of the ECB's monetary policy. Indicating that they had hoped the ECB would adopt a much stronger focus on the largest economy of the euro area, they clearly pointed out that the main

Table 8 Predicted and actual reforms

	Fiscal institutions		*Wage-setting institutions*	
	Predicted reforms	*Actual reforms*	*Predicted reforms*	*Actual reforms*
France	None	None	None	None
Germany	Centralization of fiscal spending or enhanced control of subnational spending	None (largely failed attempt to establish a national stability pact in 2003)	None	None
Austria	Centralization of fiscal spending or enhanced control of subnational spending	Domestic stability pacts (2000, 2003)	None	None
Belgium	Increased effectiveness of the budgetary procedure	Delegation of decisions on budgetary balance to the CSF (from 1994)	None	None
Spain	Centralization of fiscal spending or enhanced control of subnational spending Increased effectiveness of the budgetary procedure	Enhanced control of subnational spending, domestic stability pact (2002) Several reforms of the budgetary procedure (1994–2000)	Increased government involvement in wage-setting Stronger hierarchical organization (internal leadership) within wage-setting institutions	Direct negotiations between government and wage-setters from 1996 onwards Social Pact 1996

Table 8 Continued

	Fiscal institutions		*Wage-setting institutions*	
	Predicted reforms	*Actual reforms*	*Predicted reforms*	*Actual reforms*
Portugal	Increased effectiveness of the budgetary procedure	Reform of the budgetary procedure (2000–2001)	Increased government involvement in wage-setting Stronger hierarchical organization (internal leadership) within wage-setting institutions	Direct negotiations between government and wage-setters from 1996 onwards Social Pact 1996
Ireland	Increased effectiveness of the budgetary procedure	Reform of the budgetary procedure (1997)	Stronger hierarchical organization (internal leadership) within wage-setting institutions	Various Social Pacts and creation of appropriate incentives through 'political exchange'
Italy	Increased effectiveness of the budgetary procedure	Reform of the budgetary procedure (1997) Enhanced control of subnational spending, domestic stability pact (1999)	Increased government involvement in wage-setting Stronger hierarchical organization (internal leadership) within wage-setting institutions	Direct negotiations between government and wage-setters from 1993 onwards Various social pacts from 1993 onwards
Finland	Centralization of fiscal spending or enhanced control of subnational spending	None (But successful creation of 'EMU buffers')	None	None
Netherlands	None	None	None	None

obstacle to fiscal stabilization was the deeply rooted tradition of fiscal decentralization in Germany. The role of the German *Länder* as a co-legislator on matters concerning their own spending authority makes a step towards greater fiscal centralization almost impossible to implement.

France joined a de facto monetary union with Germany in the late 1980s (the last devaluation of 6% vis-à-vis Germany took place in 1986). In France, no reforms were expected since the highly centralized and effective budgetary system was already well in place before the start of stage three of EMU.

In short, the patterns and motivations of institutional adjustment in three of the four country cases are broadly in line with the expectations of the approach. What should be highlighted at this stage is the fact that none of the three countries made any serious attempt to build so-called 'social pacts' between government and wage-setters. Although this is sharply in contrast with the experiences of countries in the second group, this lack of consultation with wage-setters comes as no surprise for the approach chosen in this paper, since the specific economic situation faced by these countries simply did not call for such 'social pacts'.

Institutional adjustment in countries facing low real interest rates

Ireland, Portugal and Spain had to expect a context of cyclical overheating from joining EMU. They thus needed close cooperation between fiscal policy-making and wage-setting. The approach of this paper is confirmed by the patterns of institutional adjustment in all three countries.

Ireland's de facto accession to EMU took place in late 1998, when Irish interest rates sharply decreased to come close to the nominal level expected by the ECB from 1999 onwards. Ireland was expected (i) to increase the effectiveness of its budgetary procedure, (ii) to generate internal leadership in the wage-setting system. Both reforms were implemented.

Ireland's budgetary procedure was significantly altered in 1997 when the Irish finance minister was given the right to veto spending positions agreed by parliament if these positions were considered to go against the macroeconomic stance chosen by the government (de Haan et al., 1999, note a significant increase in comparison with the von Hagen indicator). Reform of the Irish wage-setting structure was a more difficult task.[7] Because the Irish government could not impose internal leadership on unions, it tried to develop incentives that would convince the group of unions to ensure implementation of wage agreements struck at the central level. It offered to cut taxes in exchange for actually implemented real-wage restraint ('political exchange'; see Pizzorno, 1978; Ebbinghaus and Hassel, 2000). There are now several indications that this attempt actually resulted in much stronger internal cohesion of the wage-setting process, thus producing to a certain extent the desired institutional reform (Hancké, 2002).

Spain's de facto accession to EMU dates back to the mid 1990s. The last realignment in the EMS took place in 1995 (+7%) and one year later the Aznar government was largely elected upon the commitment to move from a soft to a hard peg. Spain's system of economic policy institutions had to be completely overhauled in the context of joining EMU. None of the four institutional criteria in fiscal policy-making and wage-setting was met by Spain in the early 1990s.

The reform of the budgetary procedure took place in several steps between 1994 and 1999 (OECD, 2000b), before a far-reaching reform was finally implemented in 2000. In that reform, a clear administrative distinction was introduced between the economic ministry, in charge of defining the macroeconomic impact of fiscal policy, and the finance ministry, in charge of allocating the overall amount decided upon by the economic ministry to the other ministries. Starting in 1995, Spain also made several attempts incrementally to change the clearly decentralized system of public spending. Although the complex interplay between the regions and the central government has not been fundamentally altered (Gordo and Hernández de Cos, 2000), since 1997 the central government has the right to veto regional budgets based on increasing debt and deficits (Hallerberg et al., 2001). This last measure clearly fits the framework of this paper because it makes it possible for the central government to prevent regions from running pro-cyclical deficits in the context of cyclical overheating.

In wage-setting, reforms started after the election in 1996 when the Aznar government succeeded in building an unprecedented dialogue with the unions by threatening to privatize the public pension system and withdrew this plan only when the unions agreed to enter into direct negotiations with the government (Pérez and Pochet, 1999). In an approach that is very similar to that of the Irish government, the Spanish government then tried to end conflicts between the two main unions (UGT and CC.OO) by suggesting a 'social pact' based on an exchange of real-wage restraint for tax cuts. This measure was largely successful and established clear leadership in the Spanish wage-setting system, while also increasing governmental influence over collective bargaining (see mainly the two country reports on Spain for 2001 and 2002 of the European Industrial Relations Observatory).

Portugal's de facto accession to EMU also took place in the mid 1990s. In 1994, almost the complete executive of the Banco de Portugal was changed, with the aim of finally obtaining a firm commitment from the central bank to the EMS (Torres, 1998: 193–4). The last realignment took place (+3.5%) in 1995, and the new Guterres government was elected largely on the basis of preparing Portugal for EMU accession. Portugal was expected to adjust its institutions in three areas: to increase the effectiveness of the budgetary procedure; to increase government involvement in wage-setting; and to generate stronger internal leadership in collective bargaining.

The budgetary procedure was completely overhauled with the 'Framework Law for the State Budget' (2001) and the 'Budgetary Stability Law' (2002). Both reforms considerably strengthened the ministry of finance by providing it with the opportunity to establish an overall fiscal stance before entering into negotiations with ministries; it also obtained the right to reject claims by other ministries to increase spending beyond a predetermined level (see Bronchi, 2003, for a detailed discussion).

In wage-setting, reforms were implemented in two steps. First, in 1996, there was a clear and explicit attempt by the government to end the relationship of 'no trust' between government and unions (da Paz Campos Lima and Naumann, 2000). In December 1996, the 'Strategic Concertation to Modernize Portugal' social pact was signed. It contained far-reaching measures on joint economic policy management by government and unions and largely contributed to ending the often conflictual competition between the CGTP and UGT unions (da Paz Campos Lima and Naumann, 2000).

The similarities between the three EMU member states facing low real interest rates and high growth are striking. All of them had to make considerable adjustments to their institutions. All of them used the approach of establishing a social pact to seek to convince wage-setters to contribute to cyclical stabilization, thus generating stronger internal leadership in collective bargaining while enhancing governmental influence over wage-setting.

Institutional adjustments in countries with indeterminate real interest effects

Italy, Finland and the Netherlands do not really fall into either of the patterns of the previous groups. No clear economic prediction could be made about the effect that these countries had to anticipate in the run-up to EMU.

Finland's de facto accession to EMU took place between 1996 and 1998, when the Bank of Finland succeeded in defending the hard peg while continuing to bring nominal interest rates closer to the joint EMU level at the end of 1998. Finland's business cycle is structurally very different from that in the rest of the euro area (see OECD, 1998b) and thus Finland had to prepare for cyclical corrections as a reaction to asymmetric shocks and/or a destabilizing monetary policy by the ECB. Finland therefore very explicitly entered a discussion on how to use wage-setting and fiscal policy-making as cyclical stabilizers. Finland was expected to centralize its fiscal spending or at least to enhance control over subnational spending. Although neither of these reforms was implemented as such, Finland found a rather creative different solution that fully confirms the expectations of this paper: the so-called 'EMU buffers'.[8]

Starting in 1998, employers, employees and the government began to put money into a fund that would be large enough to finance aggregate wage adjustments of 3% for all wage earners in Finland by keeping the social security contributions of employers constant during a downturn. This wage adjustment is the equivalent of a nominal exchange rate adjustment of 10%. The EMU buffers are thus an interesting middle way between fiscal stabilization and wage-setting adjustments: functioning to a certain extent like insurance (in this case financed by the government and wage-setters), the system allows adjustments to be made to the pressures arising from EMU independently from year-to-year fiscal policy-making or wage-setting. In short, although Finland was identified as a special case in this paper, the establishment of the 'EMU buffers' is further confirmation of the direct link between joining EMU and the design of appropriate institutions to counter the destabilizing effects of EMU.

The Netherlands constitutes a special case from various perspectives. First, it had already joined a de facto monetary union with Germany in 1979. Second, no clear type of economic pressure could be identified. Third, it was identified as the only country not expected to undertake any reforms since the appropriate institutions were already in place. In fact, after deciding in the early 1980s to follow German monetary policy very closely, the Wassenaar agreement (1982) implemented the changes that the approach of this article expected from some EMU members after their de facto accession.

However, even in the Dutch case there are clear signs of preparatory measures in anticipation of cyclical destabilization under EMU. Most importantly, the second Kok government established an 'automatic' system allowing the use of fiscal policy in the context of cyclical destabilization (especially a downturn). The system establishes a procedure for adjusting the budget to unforeseen cyclical circumstances. Missing budgetary income is compensated 75% by new debt and 25% by tax increases if the budgetary deficit is lower than 1.75% of GDP before the adjustment procedure. If it is higher than 1.75% of GDP, the share of tax increases rises to 50% (Hallerberg et al., 2001; Ewijck and Reininga, 1999). The main objective of this procedure was clearly to avoid lengthy political discussions about tax increases at a time of cyclical pressure and thus a need for rapid stabilization. Although the Netherlands had already fulfilled the institutional prerequisites for an effective stabilization policy before joining EMU, additional adjustments were nonetheless implemented so as to make the Dutch system able to react swiftly to cyclical imbalances.

Italy's de facto accession to EMU can be situated somewhere between 1995 and 1998. During that three-year period, Italian economic policy basically did everything to get into the EMU club. In 1996, real interest rates reached a record 6%, accompanied by a strongly contractionary fiscal policy stance – a more restrictive economic policy is hard to imagine (see OECD, 1997: 46–68). However, even before that period, the pressure in Italy to prepare for EMU was high, especially considering the challenge of meeting the Maastricht criteria, which were quite bluntly targeting the Italian case (Dyson and Featherstone, 1999: 532–3). Italy was expected (i) to increase the effectiveness of its budgetary procedure, (ii) to increase government involvement in wage-setting, and (iii) to generate internal leadership in collective bargaining.

In the area of fiscal policy, the reform of the budgetary procedure was implemented in 1997. The reform, which considerably strengthened the government vis-à-vis the parliament and also gave the finance ministry the possibility of setting binding budgetary ceilings, not only helped to achieve the 'miracle' of the Italian budget in 1997 but also quite explicitly aimed at allowing cyclical stabilization after the start of EMU (Felsen, 1999; OECD, 2000a: 74). Overall, the budgetary procedure was clearly rendered more effective (see de Haan et al., 1999).

In 1999, a national stability pact was implemented to revise the seven-year-old law on the decentralization of fiscal spending. This measure is of particular interest because it clearly went against the recommendations of the Organization for Economic Co-operation and Development (OECD), which encouraged Italy to decentralize rather than to re-centralize fiscal spending authority (OECD, 2000a).

Reforms in the Italian wage-setting system took place before the de facto date of entry into EMU. After the abolition of indexed wage-setting ('scala mobile') in 1992, a social pact was signed under pressure from the government in 1993.[9] This pact was then subsequently renewed and established a system of decentralized coordination (Regini, 2000) that clearly established stronger internal leadership within collective bargaining while also increasing government involvement in wage-setting (Regalia and Regini, 1999). Although the Italian reforms in wage-setting thus fit the expectations of this paper, there are good reasons to believe that they were implemented with the aim of meeting the Maastricht criteria rather than primarily focusing on cyclical stabilization after the start of EMU.

Conclusion

This article has explained institutional reforms in fiscal policy and wage-setting in 10 EMU member states since the mid 1990s. Arguing that EMU member states had to anticipate a destabilizing impact on their domestic economic cycles from the 'one size fits all' monetary policy of the ECB, it has described institutional reforms as an anticipated adjustment process to expected economic pressures arising from EMU. The overview of actual adjustment processes in the 10 EMU member states studied here largely confirms the approach of this article.

The findings of the article indicate that a central impact of EMU on domestic economic policy institutions can be captured only within a short-term or cyclical perspective on economic policy-making. Although this conclusion should not come as a surprise to economists, it adds an important dimension to recent research in political science. Indeed, the most influential studies in comparative political economy on the interplay between the single monetary policy and domestic economic policy-making have so far put their main emphasis on long-term factors. Assuming that monetary policy, fiscal policy or wage-setting tend to adopt certain types of long-term orientations (mainly 'restrictive' vs. 'expansionary' or 'accommodative' vs. 'non-accommodative'), differences in cross-country performances were derived from theoretical models of how these long-term orientations could be linked to underlying institutional features (see several contributions in Iversen et al., 2000, as well as in Hall and Soskice, 2001).

The heuristics of this literature have been used to study the impact of EMU on economic performance by treating EMU as a single economic unit (Hall and Franzese, 1998; Iversen, 1998; Iversen, 1999a,b; Soskice and Iversen, 1998). As the results of this article suggest, however, this approach might not be completely satisfactory. There are good reasons to believe that the implementation of EMU has resulted in a strengthening of domestic institutions in fiscal policy-making and wage-setting. The appropriate level of analysis could thus still be domestic, yet under the constraints of the single monetary policy. Moreover, the hypotheses of such approaches might need to focus more closely on the link between institutions and their roles as instruments in cyclical stabilization, rather than studying exclusively long-term trends.

From the wider perspective of research on European integration, this article's suggestion that EMU actually brought a renaissance of domestic economic policy institutions might shed new light on discussions related to the coordination of economic policies in EMU. There might be a good case for preserving a relatively high degree of national autonomy in fiscal policy and wage-setting, rather than attempting to embed national economic policy choices within a framework of firm coordination at the European level (see Enderlein, 2004b).

Finally, the article also points to the need for a wider definition of institution-focused comparative political economy. Studying monetary policy, fiscal policy and wage-setting in parallel, instead of limiting research to only one of these three areas, could be a fruitful exercise.

Notes

This article derives from a larger project on the adjustment of domestic economic policy institutions to EMU (Enderlein, 2004a). I am grateful to Fritz W. Scharpf, Alberta Sbragia, Mark Hallerberg, Bernhard Kittel, Martin Höpner, Michael Zürn and the referees for comments and support.

1 De Haan et al. (1999) present a similar indicator. However, because they include reforms implemented during the 1990s, they already capture the effect of adjustment to EMU.

2 Owing to space constraints, it is not possible to make a detailed assessment of the debate on centralized (Cameron, 1984; to some extent also Calmfors and Driffill, 1988, with the 'hump-shape' hypothesis) vs. coordinated (Soskice, 1990) systems. See Kenworthy (2001, 2003) for an overview of quantitative indicators of corporatism.

3 Social theory generally points to the difficulties decentralized institutions have in accepting 'deferred gratification' (i.e. the acceptance of today's losses in view of future gains) in a system of collective action that might be subject to free-riding behaviour (Elster, 1979).

4 Portugal, Ireland and Spain are not covered by the GWL data set. These cases were analysed and scored individually, mainly on the basis of analyses in the *European Industrial Relations Review*.

5 The cutting point between systems with 'high government influence' and 'low government influence' was set between 4 and 5: 4 refers to cases in which governments provide wage-setters with macroeconomic data only, whereas 5 indicates that governments make concrete and clear wage recommendations to wage-setters. In line with the literature, Italy was put into the group with low government influence (Regalia and Regini, 1999; Regini, 2000). Cases not covered by GWL (Ireland and Portugal) were taken from a comparable assessment in Traxler et al. (2001).

6 In contrast to Austria and the Netherlands, Belgium had preserved its truly domestically oriented monetary policy during the 1980s and early 1990s. Indeed, whereas the r^2 for the correlation coefficients for short-term interest rates between Germany and Austria/Netherlands is .96/.92 for the period 1982–95, it is as low as .29 in the Belgian case.

7 This paragraph builds on country reports on Ireland in the European Industrial Relations Observatory. The reports are available online at URL: http://www.eiro.eurofound.eu.int.

8 The following exposition draws on Alho (2000) and the relevant country reports of the European Industrial Relations Observatory.

9 The *European Industrial Relations Review* described this offer under the title 'Take It or Leave It' (No. 236, 1993: 23).

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