



# A Policy Mix for the Euro Area

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**T**he recovery appears well underway in the United States and the United Kingdom. The euro area on the other hand is struggling to pick up, yet has been hit by no specific shock since 2012. What is the responsibility of the Eurozone's macroeconomic policies and what is that of Member States' more structural problems? The purpose of this *Note* is to identify macroeconomic management failures in the euro area and to propose pragmatic shifts while exploring possible avenues for further far-reaching reforms.

Both the Eurozone crisis and its slow recovery have shed light on the limits of Member States' economic policy coordination, which quite plainly amounts to little more than coordination on the issue of fiscal sustainability. Three essential channels of interaction between Member States' economic policies have been overlooked since 1999, with recent reforms failing to address this problem in any substantial manner. Firstly, on competitiveness: by not coordinating price and wage variations relative to their main trade partners, euro members allowed wide nominal divergences to settle between them. Secondly, on financial imbalances: where was private debt, when public debt was in the limelight?; such financial imbalances nurtured nominal divergences. Lastly, on demand management: Member States maintained a

demand gap by not sufficiently coordinating how they handled the consequences of the financial crisis. These elements imply that economic policy coordination should be extended over and beyond surveillance of public debt levels, and should encompass competitiveness policies, demand management and macro-prudential policy.

Macroeconomic governance in the euro area, which falls under the heading of "European Semester", suffers from three major shortcomings: a Eurozone-level that is insufficiently developed and integrated with the Member-States-level; an unclear dividing line between short or medium-term surveillance (fiscal and macroeconomic imbalances) and long-term monitoring (Europe 2020 growth strategy); poor ownership of European-level recommendations at national level. In the short run, there is no need to change the instruments, and even less so the rules, to move forward on these three avenues; what is required is that they be better articulated.

We make eight proposals to give the European Semester its full meaning, to better integrate the Eurozone and Member States levels and to rebalance the surveillance process between fiscal, macro-prudential and competitiveness matters. These proposals should be viewed as a first step on the road towards further integration.

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All major advanced economies were hit in 2009 by a crisis of exceptional magnitude, followed by a rebound in 2010 and 2011; all three of the Eurozone, the United States and the United Kingdom followed this pattern. Yet, the euro area was the only one to suffer from a relapse from 2012 onwards. While growth did turn positive in 2014, its pace is no match for that of the UK and especially of the US. Given that no specific exogenous (independent of its own organisational structure) shock hit the euro area in 2012-2013, how can one make sense of this situation?

Member States hold the keys to the primary drivers of growth: they are responsible for both long-term growth-enhancing structural policies and for counter-cyclical fiscal policies, although the latter can only be implemented when public debt levels and initial deficits are sufficiently low. Many Eurozone countries –France included– entered the downturn with a budget deficit of close to 3% of GDP. Others –Spain or Ireland– had enjoyed pre-crisis surpluses; yet, their weak taxation base (highly dependent on the real-estate sector) was also hard hit by the very acute recession, resulting in severe financial constraints. As for the European Central Bank (ECB), the banking crisis limited the effectiveness of its policy, as did the zero lower-bound constraint on the interest rate and the euro area’s lack of financial market integration. Neither national nor European levers could be fully utilised to stabilise the situation.

The purpose of the *Note* is to examine what could be improved in the macroeconomic governance of the euro area in the short term and to explore possible avenues to further far-reaching reforms.

## What went wrong in the euro area

Without going back over the detailed genesis of the crisis,<sup>1</sup> it is possible to single out a few key policy failures.

The economic policy framework introduced in 1999 with the adoption of the single currency can be summed up quite simply. The ECB, independent of governments, was mandated to ensure “stable” Eurozone prices on average. Member States retained competence over their fiscal policy, which was to respond above all to asymmetric shocks between States, while the ECB was to take over a large share of the response to symmetric shocks. The Stability and Growth Pact (SGP)<sup>2</sup> was annexed to the Treaty to ensure the independence of the central bank. The idea was to prevent governments from reaching unsustainable debt positions; in turn, this would guard the ECB from having to monetise public debt in order to avoid a sovereign default and the ensuing financial crisis.<sup>3</sup>

Economic policy coordination<sup>4</sup> between Member States was given low priority, in spite of the warnings from some of the founding fathers of the euro<sup>5</sup> and of being in the Treaty (art. 121): it was felt that if each country had its house in order, then the great European house would be in order too. The main instrument of economic policy coordination (Broad Economic Policy Guidelines, BEPG) proved to be a formal exercise lacking in substance as no sanctions were provided for.

The pre-crisis failure of the SGP to contain public deficits and reduce public debt levels explains only part of the prolonged Eurozone crisis. Another leading cause was overlooking three essential channels of interaction between States’ economic policies:

- Competitiveness;
- Financial imbalances;
- Demand management.<sup>6</sup>

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<sup>1</sup> See for example Pisani-Ferry J. (2014): *The Euro Crisis and its Aftermath*, Oxford University Press, or Bénassy-Quéré A. and B. Cœuré (2014): *Économie de l’euro*, La Découverte, Coll. Repères, 3<sup>rd</sup> edition.

<sup>2</sup> Economic governance in the Eurozone makes intensive use of acronyms. Here are some of the main ones: SGP stands for Stability and Growth Pact; EDP for Excessive Deficit Procedure; MIP for Macroeconomic Imbalance Procedure; AGS for Annual Growth Survey; AMR for Alert Mechanism Report; IDR for In-Depth Review; CSR for Country Specific Recommendations; DBP for Draft Budgetary Plans.

<sup>3</sup> See Eichengreen B. and Ch. Wyplosz (1998): « The Stability Pact: More than a Minor Nuisance? », *Economic Policy*, vol. 13, no 26, pp. 65-104. On “fiscal dominance”, see Woodford M. (2001): « Fiscal Requirements for Price Stability », *Journal of Money, Credit and Banking*, vol. 33, no 3, pp. 669-728.

<sup>4</sup> Here, economic policy coordination refers to each country taking into account the impact of its policies on other Members States vs integration’s pooling of policy instruments (such as monetary policy).

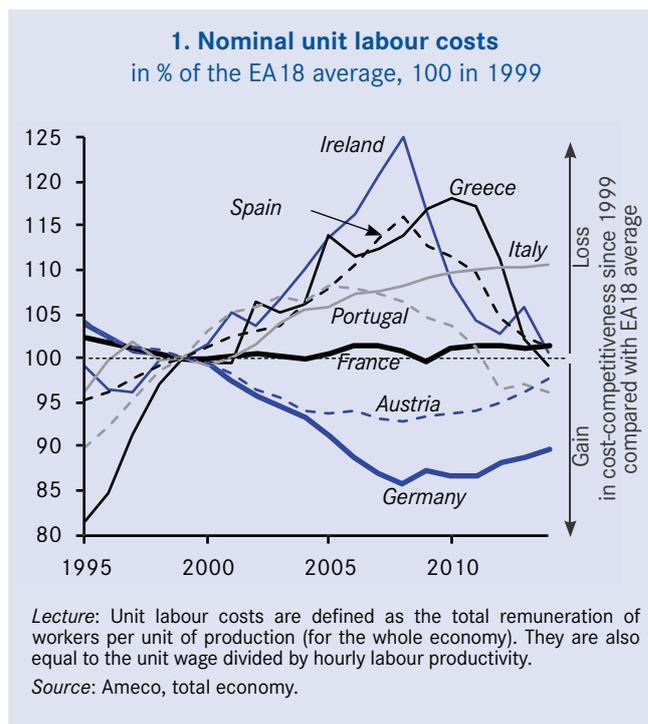
<sup>5</sup> “The combination of a small Community budget with large, independently determined budgets leads to the conclusion that, in the absence of fiscal coordination, the global fiscal policy of EMU would be the accidental outcome of decisions taken by Member States. As a result, the only global macroeconomic tool available within EMU would be the common monetary policy implemented by the European Central Bank”, see Lamfalussy A. (1989): *Macro-Coordination of Fiscal Policies in an Economic and Monetary Union in Europe*, Collection of Papers, Committee for the Study of Economic and Monetary Union, Luxembourg, p. 101.

<sup>6</sup> Martin and Philippon (2014) use counterfactual simulations to show that a more cautious fiscal policy before the crisis would have reduced its impact in Greece and, to a lesser extent, in Spain and Ireland. However, Greece would have been the only one to avoid being hit by the crisis, whereas Portugal’s situation would have stayed the same. See Martin P. and Th. Philippon (2014): « Inspecting the Mechanism: Leverage and the Great Recession in the Eurozone », *NBER Working Paper*, no 20572, October. The iAGS report (2015) studies which factors weighted on European demand, see Independent Annual Growth Survey (2015): *A Diverging Europe on the Edge*.

## Competitiveness and nominal divergences

It is rather obvious to state that members of a monetary union are barred from using periodic devaluations to address their drifting price-competitiveness. Member States nevertheless failed to closely monitor the evolution of their costs and prices relative to that of their main partners. As Figure 1 illustrates, the divergence pre-dates monetary unification and has resulted in major discrepancies in real exchange rates between Member States. Explanations are threefold. First, the peculiar trajectory of wages in Germany is the result of the decentralisation of the wage bargaining process in the second half of the 1990s, following German reunification.<sup>7</sup> Second, capital inflows in some peripheral countries bolstered private consumption and encouraged the development of non-tradable sectors with low productivity gains, the first of which is the construction industry. Increases in consumer prices, real-estate prices and nominal wages followed (these three dynamics being mutually reinforcing), especially in Ireland and Greece and to a lesser extent in Spain. This is a failure of the liberalisation of capital flows without proper supervision in the 2000s: capital found itself invested in bubbles rather than in the productivity catch-up.<sup>8</sup> A third element was the surprisingly sluggish productivity in countries such as Spain and Italy over the 2000s, which contributed to the relative increase of their unit labour costs compared to other European countries.

These nominal differences have been largely addressed since the beginning of the crisis in Ireland, Greece, Portugal, and Spain (not so in Italy). However, the adjustment was asymmetrical and based mainly on the curtailment of unit labour costs in crisis countries. In a fixed exchange-rate regime, asymmetric price adjustment is known to introduce a deflationary bias. The new macroeconomic imbalances procedure (established in 2011; see below) can be read as an attempt to apply part of Keynes's 1942 ideas to the European Monetary Union.<sup>9</sup> Yet, the procedure itself is asymmetrical (with more importance granted to deficits than to surpluses), leading to a deflationary bias weighing on the Eurozone; this bias is reinforced by the impact that lower prices have on the debt ratio of countries initially in deficit.



## Financial imbalances

In most countries, rising public debt was a consequence to the financial and economic crisis. For example, the Irish government, in a bid to avoid the destabilisation of the European financial sector, extended a blanket guarantee to Irish banks at the beginning of the crisis. Public debt surged from a pre-crisis 25% of GDP to a peak of 123% of GDP in 2013 and government revenues, driven by real-estate, were also severely hit; yet private debt (households, non-financial companies and banks) was not being monitored before the crisis. In 2001, when the Council issued a recommendation to Ireland under the BEPGs, the prescribed remedy to the economy's overheating was to implement a more restrictive fiscal policy, in spite of the country already enjoying a surplus; slowing the credit bubble by using instruments such as mortgage regulation (higher input and/or income requirements for loans) was not part of the recommendations.

<sup>7</sup> See Dustmann Ch., B. Fitzenberger, U. Schönberg and A. Spitz-Oener (2014): « From Sick Man of Europe to Economic Superstar: Germany's Resurgent Economy », *Journal of Economic Perspectives*, vol. 28, no 1, pp. 167-188. It would appear that the decentralisation of the wage bargaining process played a much greater role than did the "Hartz" laws which entered into force in 2003, see Beuve J. and B. Françon (2015): « Les lois Hartz 10 ans après, quels enseignements? », *Focus du Conseil d'analyse économique*, no 2, forthcoming.

<sup>8</sup> The role played by capital inflows in the run-up to the crisis was highlighted by Giavazzi F. and L. Spaventa (2010): « Why the Current Account May Matter in a Monetary Union: Lessons from the Financial Crisis in the Euro Area », *CEPR Discussion Paper*, no 8008 and Wyplosz Ch. (2013): « The European Quest for Fiscal Discipline », *European Commission Economic Papers*, no 498. The drift in relative prices cannot be isolated from the issue of financial imbalances.

<sup>9</sup> Keynes' plan aimed at rebalancing the weight of adjustment between creditors and debtors in a fixed exchange-rate regime. A country with an "excessive" external imbalance, whether it be a surplus or a deficit, would have had to pay a fine of up to 2% of the amount of the imbalance into an international reserve fund. See "Proposals for an International Currency (or Clearing) Union" by John Maynard Keynes in 1942, taken up by Horsefield J.K. (1969) : *The International Monetary Fund 1945-1965. Twenty Years of International Monetary Cooperation*, vol. III, International Monetary Fund.

Europe's debt consolidation strategy continues to this day to limit itself to the issue of public debt, which is dealt with through fiscal adjustment. The implementation of the banking union was accompanied by partial bank deleveraging, with no concerted debt consolidation strategy for households or non-financial companies being set up; in addition, reflection on alternative strategies to lower public debt levels is progressing with reluctance, under the threat of a unilateral Greek default.

The Eurozone must give a great deal of thought to the best way of restoring the credibility of the "no bailout" clause without triggering a major financial crisis, and more generally to ways of reducing debt other than through the primary budget surplus. Several suggestions have been made that go in this direction, some of which involve debt restructuring.<sup>10</sup> Further consolidation of Eurozone banks and greater diversification of their balance sheet is probably a prerequisite.

### Demand management

As noted above, the coordination of fiscal policies in the euro area is limited to trying to prevent a Member State from engaging onto an unsustainable fiscal path. This goal is not only difficult to achieve without simultaneously monitoring private debt, it is also insufficient as can be seen today. Two indicators suggest that demand in the euro area is low relative to supply:

- The drop in the inflation rate (below 0.5% in 2014; 0.7% when excluding energy and commodity prices);
- The simultaneous increase in the current external account, which is none other than the Eurozone's net savings (savings in excess of public and private investments).<sup>11</sup>

Several factors had a clear impact on these developments.<sup>12</sup> Over-indebted businesses and households opted for debt consolidation, which was met by mixed results across the continent. Fiscal consolidation policies carried out in 2011-2013 also contributed strongly to reducing demand.<sup>13</sup> Uncertainty, which weighs negatively on investments, continues to linger as a result of the loss of confidence in the stability of the Eurozone and of the political uncertainty in some countries –as can be seen in the gap in interest rates paid by Member States. Consumers' purchasing power was dampened by wage reduction policies in Southern Europe. Accordingly, companies continued to produce below capaci-

ty in 2014.<sup>14</sup> Finally, European monetary policy proved less expansionary than its British or American counterpart, particularly so between autumn 2012 and the January 2015 announcement of quantitative easing measures.<sup>15</sup>

Fiscal policy cannot play its counter-cyclical role in countries under an adjustment programme (case of Greece in 2014), in countries under the Excessive Deficit Procedure within the SGP's corrective arm (case of France) or in countries committed to reducing their deficit under the SGP's preventive arm (case of Italy). In 2014, Germany was the only major Eurozone country truly free to set its fiscal policy; it opted for a balanced budget (coalition agreement). The fiscal policy of Eurozone members is thus largely inactivated, in spite of the Commission's efforts to relax the SGP rules, in particular with regard to its preventive arm.<sup>16</sup>

Could the adjustments made by the peripheral countries have been partially offset by a less restrictive German fiscal policy? The literature on Keynesian cross-multipliers (the impact of one country's stimulus on another's economic activity) offers little in the way of encouragements: a fiscal stimulus in Germany has an ambiguous effect on Italy or France because of the resulting rise in Eurozone-wide interest rates. However, this literature only covers "normal" time periods. In a period of prolonged monetary expansion, the interest rate channel is neutralised and a less restrictive German fiscal policy would unambiguously have supported activity elsewhere in the euro area. Germany, which enjoys a situation of full employment, had however no reason not to get back to a balanced budget.<sup>17</sup>

## A poor organization

### Institutional constraints

The Eurozone is not a federal state. Had it been, it could have taken quicker decisions and substantially reduced the cost of adjustment. For example, the delay in tackling the banking crisis can be directly linked to there being no federal agency to address it at the beginning of the crisis. Furthermore, a federal Eurozone would have set its fiscal policy at a central level, taking into account the economic situation at the time, and coming under a lot less market-pressure given that its

<sup>10</sup> See Buchheit L.C., A. Gelper, M. Gulati, U. Panizza, B. Weder di Mauro and J. Zettelmeyer (2013): *Revisiting Sovereign Bankruptcy*, Committee on International Economic Policy and Reform, Bookings, and Paris P. and Ch. Wyplosz (2014): PADRE 2.0: *Politically Acceptable Debt Restructuring in the Eurozone 2.0*, CEPR, Geneva Reports on the World Economy, May.

<sup>11</sup> The surplus reached 2.7 percent of GDP in 2014, after having been close to balance between 2000 and 2011.

<sup>12</sup> See Martin and Philippon (2014), *op. cit.*

<sup>13</sup> See the iAGS (2015) *op. cit.*

<sup>14</sup> The precise level of post-crisis production capacity (potential growth) is highly controversial; however, it is accepted that GDP remains below potential in 2015.

<sup>15</sup> See Bénassy-Quéré A., P.O. Gourinchas, G. Plantin and Ph. Martin (2014): « The Euro in the 'Currency War' », *Note du CAE*, no 11, January.

<sup>16</sup> See the Press release by the European Commission (2015): « Making the Best Use of the Flexibility Within the Existing Rules of the Stability and Growth Pact », *COM(2015) 12 Final Provisional*, 13 January.

<sup>17</sup> See Blanchard O., C.J. Erceg and J. Lindé (2014): *Jump-Starting the Euro Area Recovery: Would a Rise in Core Fiscal Spending Help the Periphery?*, Mimeo, 30 June.

overall debt level compares with that of the US. As for the ECB, it would have had a standard instrument for balance sheet management at its disposal. In addition, the banking risk-sovereign risk loop would have been mitigated by banks holding federal rather than national sovereign bonds on their balance sheet.

Instead, and with the exception of the 2009 stimulus package, the fiscal response to the crisis was in no way coordinated, but by the SGP's rules whose aim is to ensure fiscal sustainability and not to manage the economic cycle. Although the SGP rules were amended in 2005 to better reflect the business cycle (see Box), they have been rather unsuccessful in achieving demand stabilization: firstly because the SGP relies on the notoriously difficult-to-compute indicator of potential GDP (used to calculate the structural balance) and secondly because the SGP's new guidelines offer very limited genuine "flexibility", especially to those countries with a deficit in excess of 3% of GDP.

Having pledged to coordinate their economic policies (art. 121 of the Treaty on the Functioning of the European Union, TFEU), Member States still struggle to see through this coordination other than *via* the SGP rules. This hardly comes as a surprise, given that governments derive their legitimacy from national elections and not European ones. This difficulty is well-illustrated by the German coalition agreement, which came into force following the 2013 elections,<sup>18</sup> and which led Germany –representing 25% of the Eurozone's GDP– to return to a balanced budget faster than foreseen in the SGP. In a federal union, this would not have been an issue. Indeed, in existing federal countries (USA, Canada, Brazil, Switzerland...), macroeconomic stabilisation is provided for by the federal budget, be it with temporary transfers between States (federal unemployment insurance for example) or with the ability to borrow in times of crisis.<sup>19</sup> With no federal budget, coordination of Eurozone fiscal policies is made all the more necessary; however, because each Parliament is sovereign in approving its national budget, such coordination contradicts national political systems.

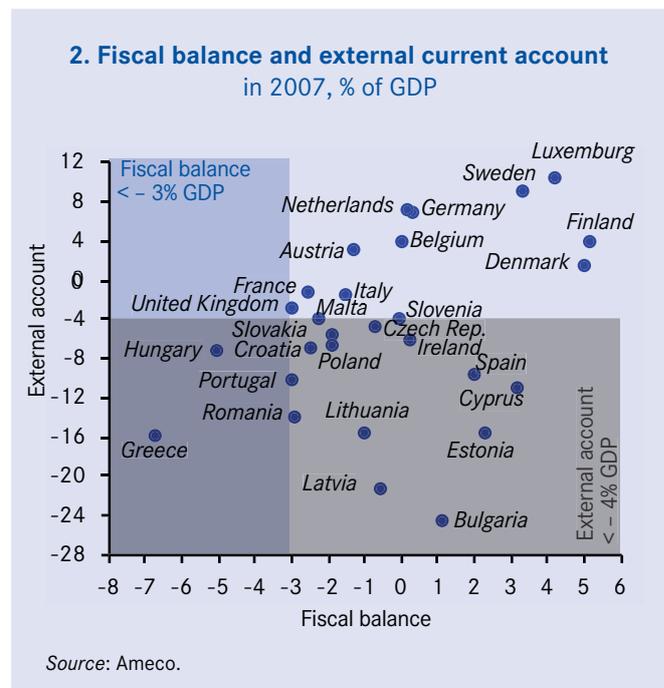
The lack of consistency in State-level policies has resulted in monetary policy taking full responsibility for managing aggregate demand in order to achieve the objective of an inflation rate "below 2%, but close to 2%".

In the nutshell, the euro area lacks a central decision-making power that would act more swiftly and efficiently than a com-

bination of weakly coordinated Member States. This will weigh on economic policy making until the institutional setup is revised.

### A macroeconomic surveillance that is doubly-asymmetric

The imbalances that led to the Eurozone crisis were of a budgetary nature for some countries (Greece), but not so for others (Ireland, Spain). Indeed, while not all countries hit by the crisis ran a high budget deficit in 2007, all had recorded large external deficits (Fig. 2); this is linked to rising private debts. The fiscal balance of pre-crisis Spain was clearly in surplus but a combination of rising real-estate prices and negative real interest rates encouraged private agents to invest in real-estate and lower their savings. This private-sector imbalance is reflected in the current account balance, which is the sum of net public savings and net private savings.



In recognition of this surveillance error, the EU widened the monitoring process in 2011 with the introduction of the Six Pack<sup>20</sup> and its Macroeconomic Imbalance Procedure (MIP, see Box). The MIP is not based on specific policies, as opposed

<sup>18</sup> France can hardly be said to have proved very reliable on coordination, see Pisany-Ferry (2011) *op. cit.*

<sup>19</sup> See Bornhorst F., E. Perez Ruiz and F. Ohnsorge (2012): « Fiscal Union: Common Practices in Federal States » in *Towards a Fiscal Union in the Euro Area: Technical Background Notes*, IMF Background Papers.

<sup>20</sup> The Six Pack is a legislative package made up of five regulations and one directive. It was adopted in October 2011 to strengthen fiscal surveillance and introduce a new surveillance procedure for macroeconomic imbalances. In 2012, the Six Pack was completed by the Two Pack, a package of two regulations which aims to strengthen fiscal monitoring within the euro area by requiring Member States to submit draft budgetary plans to the Commission. The Commission then provides an assessment (and potentially requires amendments) "at the latest" by 30 November of each year. The Fiscal Compact (an intergovernmental Treaty on Stability, Coordination and Governance, TSCG) was adopted in October 2012 and requires contracting Eurozone members to respect a lower limit of a structural deficit (cyclical effects and one-off measures not taken into account) of 0.5% of GDP over the medium-term. Compliance with this rule is to be monitored by independent institutions at Member State level (in France, *Haut Conseil des Finances Publiques*). The TSCG also includes Euro Summits at least twice a year. See [http://ec.europa.eu/economy\\_finance/articles/governance/2012-03-14\\_six\\_pack\\_en.htm](http://ec.europa.eu/economy_finance/articles/governance/2012-03-14_six_pack_en.htm)

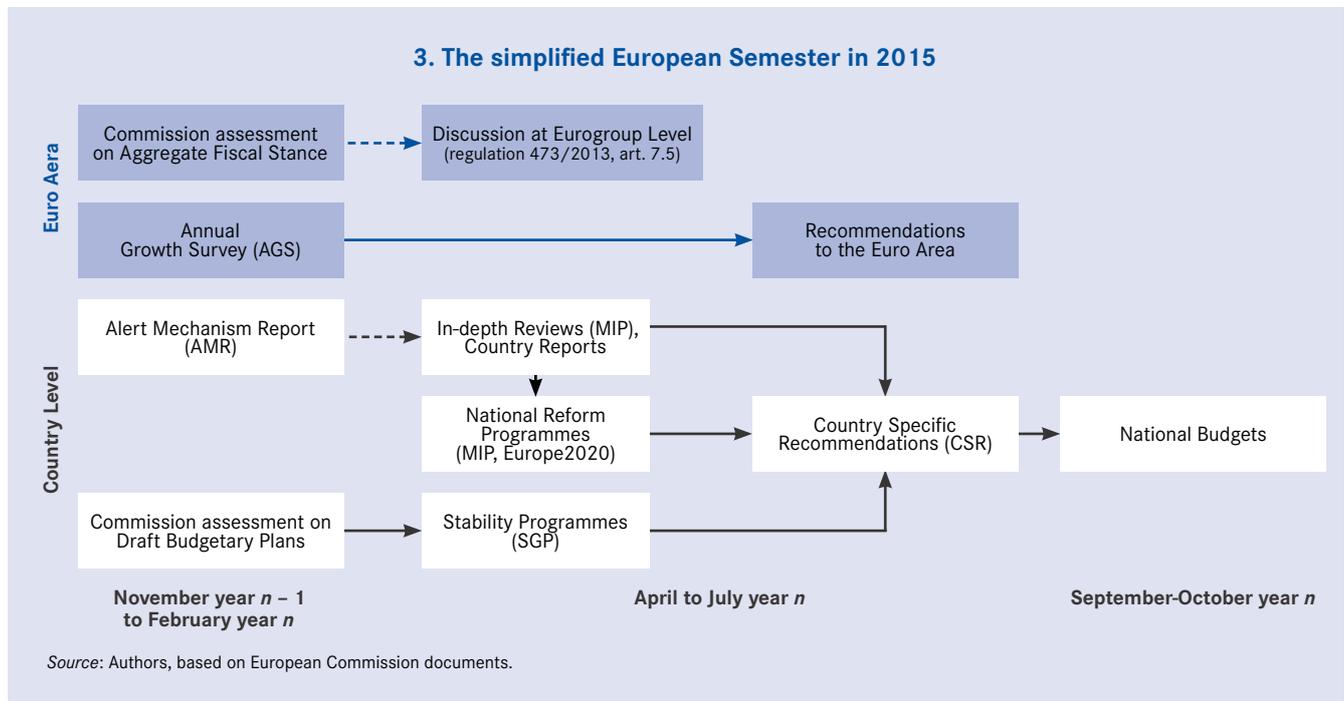
to the SGP's focus on budget balance (cyclically adjusted or not). As a result, macroeconomic surveillance gets nothing other than lost in a list of structural recommendations, some of which (reforms of the labour market, education...) should instead fall under the European growth strategy.

It is obviously desirable that the European Commission disseminate best practices in terms of structural policies in order to raise the Eurozone's potential growth prospects. However, doing so as part of the MIP weakens the procedure: countries find it nigh impossible to respond quickly to all the Commission's requests, some of which are quite distant from short and medium-term macroeconomic imbalances. In turn, the Commission may think twice about placing a country in a situation akin to it being under an ESM (European Stability Mechanism) adjustment programme.

The MIP itself was built asymmetrically. For example, the scoreboard, upon which the Commission relies to identify imbalances before performing in-depth reviews, uses different thresholds depending on whether the country has an external surplus (+ 6% of GDP) or a deficit (- 4%); additionally, some thresholds can be sensitive to the Eurozone's inflation average or even to the euro exchange-rate.

### A dichotomy between Eurozone and Member States

The "European Semester", which came into force in 2010 and runs from November to July, has restructured macroeconomic surveillance in the euro area (Fig. 3).<sup>21</sup> The Eurozone's policy mix is discussed mainly through the examination of the Annual Growth Survey at the beginning of the semester, followed by the adoption of recommendations to the euro area (end of semester). A Eurogroup discussion on the orientation of the Eurozone's aggregate fiscal stance has been planned since 2013, yet does not seem to have been the focus of much attention. Above all, these various elements of consultation at European level have no tangible impact on country-specific decisions. In 2014 for example the recommendation to the euro area asked to "foster appropriate policies in countries with large current account surpluses to contribute to positive spillovers".<sup>22</sup> However, the Council's recommendations to the two largest surplus Eurozone countries – Germany and the Netherlands –<sup>23</sup> showed no sign of this recommendation. The Netherlands were asked not to falter in their budgetary adjustment. As for Germany, it was asked to reduce taxes on low-skilled labour in order to "support domestic demand"; a very similar recommendation was made to France with a view this time to restoring competitiveness. The rapid adjustment of the German budget deficit (the 2010 deficit of 4.1% had disappeared by 2012) gave rise to no objections.



<sup>21</sup> See [www.consilium.europa.eu/fr/policies/european-semester](http://www.consilium.europa.eu/fr/policies/european-semester), the complete version is available at [ec.europa.eu/europe2020/making-it-happen/index\\_fr.htm](http://ec.europa.eu/europe2020/making-it-happen/index_fr.htm)

<sup>22</sup> Country Specific Recommendations are available at [ec.europa.eu/europe2020/making-it-happen/country-specific-recommendations/index\\_en.htm](http://ec.europa.eu/europe2020/making-it-happen/country-specific-recommendations/index_en.htm)

<sup>23</sup> Germany's current external account reached 6.9% of GDP in 2013, that of the Netherlands 8.5% of GDP. That same year, France recorded a deficit of 2% of GDP, see Ameco database.

### Weak ownership of the semester

At Member States level, the semester begins in November of year  $n - 1$  when they receive the Commission opinion on their draft budgetary plans for year  $n$  as part of the SGP: adjustments are required if they are at risk of non-compliance. The Commission already ruled in May on this issue, based on national Stability Programmes; however, the November opinion takes into account the national budgetary debate and the Commission’s new macroeconomic forecasts on growth and potential growth or inflation, also published in November. In the event that, for example, potential growth has been revised downwards, an additional effort may suddenly be required, close to the end of the budget process, if governments are to achieve their structural adjustment target. The Commission is by no means going beyond its mandate in ensuring that passed budgets comply with SGP rules. However, it is of little use to change underlying budgetary assumptions when the budget process is about to end; it merely urges governments to look for emergency solutions in finding the missing billions in a pro-cyclical way.

At the start of each European Semester, the Commission also publishes both the Annual Growth Survey (AGS) and the Alert Mechanism Report (AMR) under the MIP. The latter pinpoints critical imbalances country-by-country –be it lack of competitiveness in France or an excessive current-account surplus in Germany. The report determines for which country an in-depth review is warranted. Under the SGP, countries almost automatically fell under the Excessive Deficit Procedure when their deficit breached the 3% threshold; in contrast, the MIP suffers from having no single key indicator upon which to rely. The AMR builds on the analysis of a scoreboard that

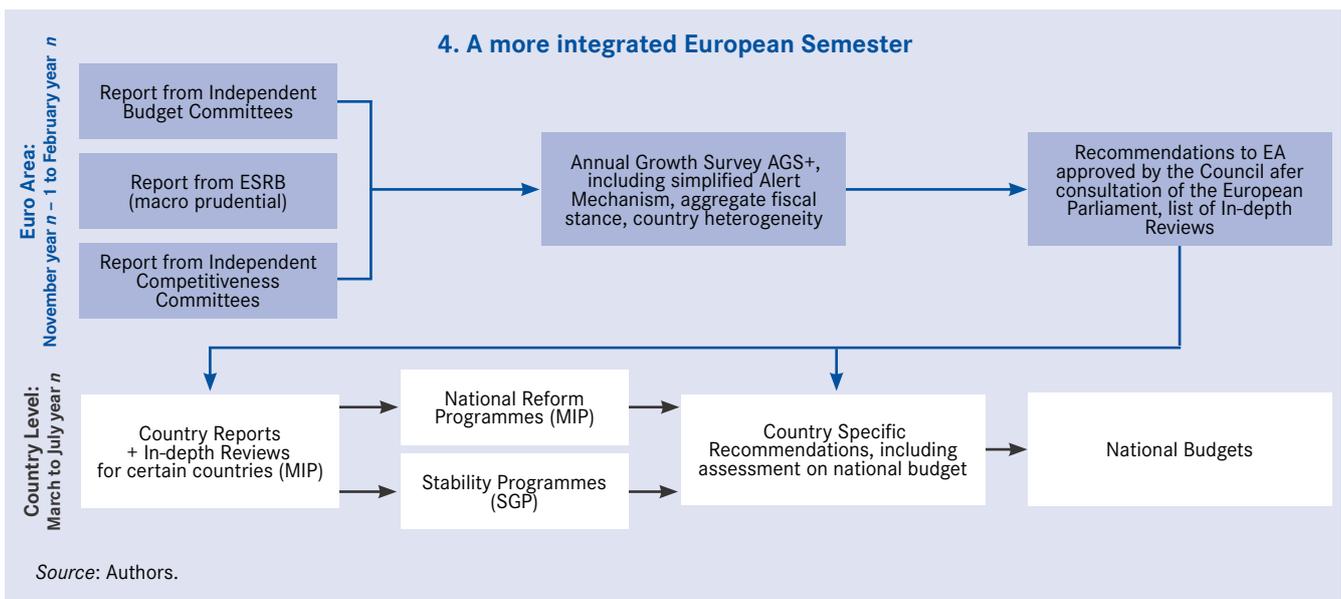
scrutinizes 11 “headline” indicators and 29 “secondary” indicators.<sup>24</sup> In-depth reviews also touch upon many issues. Using multiple criteria allows for gradual pressure on Member States (the MIP has six “step-up” stages, see Box); it also leads to some key elements of the analysis being set aside (see for example the differences between the Commission’s Country Reports and the final recommendations adopted by the Council). Upon receiving their country-specific recommendations governments tend to perceive them to be both too intrusive and not properly prioritised. Notwithstanding goals being seen as fully legitimate, they find it difficult to endorse all the requirements given a level of detail that impinges on national sovereignty.

The In-depth Reviews are submitted to Member States early in the year, so that they orient their National Reform Programmes.<sup>25</sup> These reviews are important and well-structured, but seldom debated at the national level, especially so in Parliament.

### Simplifying and creating consistency in macroeconomic surveillance

In short, the Eurozone’s macroeconomic governance suffers from three major shortcomings:

- A Eurozone level that is insufficiently developed and integrated with the Member States level;
- An unclear dividing line between short or medium-term surveillance (SGP, MIP) and long term monitoring (EU2020 growth strategy);
- Weak ownership of country-specific recommendations at national level.



<sup>24</sup> For 2015, see [ec.europa.eu/economy\\_finance/economic\\_governance/documents/alert\\_mechanism\\_report\\_2015\\_statistical\\_annex\\_en.pdf](http://ec.europa.eu/economy_finance/economic_governance/documents/alert_mechanism_report_2015_statistical_annex_en.pdf)

<sup>25</sup> Starting from 2015, Country Reports (that used to be submitted at the same time as Country Specific Recommendations in May) will be published at the same time as in-depth reviews.

## The Stability and Growth Pact (SGP)

The SGP, set up in 1997, has two components:

- A preventive arm: Member States outline their multi-annual adjustment strategy in their Stability Programme (when the euro is their currency) or in their Convergence Programme (when it is not), which goes over how they intend to reach their Medium-Term Objective (MTO) of a budget “close to balance or in surplus”. These programmes are updated yearly and subject to the approval of the ECOFIN Council, after the Commission has delivered its assessment. Public debt is also expected to converge to a value below 60% of GDP;
- A corrective arm: a Member State’s budget may not record a deficit greater than 3% of GDP, bar under “exceptional and temporary circumstances”.<sup>a</sup> The Council may deem the deficit “excessive” if this threshold is breached, in which case a procedure is implemented that carries fines of up to 0.5% of GDP.

The SGP was first amended in 2005, following the failure by a number of countries (including Germany and France) to comply with the 3% threshold. MTOs now vary according to Member States’ debt levels and growth potential; a negative growth rate or the accumulated loss of output during a protracted period of very low growth relative to potential may be deemed exceptional and temporary circumstances; structural reforms, such as pension reforms, which have a short-term cost but contribute to the long-term sustainability of public finances are taken into account; in case of excessive deficit, the adjustment of the structural balance (cyclically adjusted) must be at least 0.5 GDP percentage point per year. Overall, greater attention is paid to the structural balance, especially in high phase of the business cycle.

The SGP was amended for a second time in 2012, as part of the Six Pack and the Fiscal Treaty:

- The structural deficit now has a lower limit of 0.5% of GDP (1.0% of GDP under “exceptional circumstances”), with corrective mechanisms in case of deviation; this limit is to be implemented at national level “through provisions of binding force and permanent character, preferable constitutional”;
- Debt rule: public debt in excess of the threshold must be reduced by 1/20<sup>th</sup> annually;
- Expenditure benchmark: excess growth of expenditure over a medium-term reference rate of GDP growth must be matched by discretionary revenue measures;
- Shorter timeframes before sanctions for non-compliance are applied: “early warning” system if evidence is found of significant deviation from MTOs; non-interest-bearing deposit of 0.2% of GDP at the beginning of the Excessive Deficit Procedure; reverse qualified majority voting for sanctions; additional penalties for fraud; specific monitoring of Member States with an excessive deficit or in financial difficulty;
- Obligation for Member States to plan for a multi-annual budget and establish an independent fiscal committee.

The Commission issued guidance in January 2015 on how implementation of the SGP rules takes into account the structural reforms underway at Member State level and their business cycle.<sup>b</sup> Overall, these two factors are taken into account only to a limited extent, whether it be to determine the amount of structural adjustment

(countries under the preventive arm of the SGP) or to determine the available delay of adjustment (country under the corrective arm of the SGP).

On 1 January 2015, Excessive Deficit Procedures were ongoing for 11 Member States (including France) out of 28; the corresponding figure on 1 January 2011 was 24 out of 27.

## The Macroeconomic Imbalance Procedure (MIP)

The MIP was set up in 2011 as part of the Six Pack legislation. The MIP follows the SGP pattern and has both a preventive and a corrective arm.

The preventive arm relies on an alert mechanism based on scoreboard of risk indicators, complemented by an economic analysis by the European Commission. The conclusions are discussed by the Eurogroup; on this basis, the Council decides whether or not an in-depth review will be carried out for countries, filtering out those at risk of non-compliance. Countries are then placed in one of the six MIP categories:<sup>c</sup>

- No imbalance;
- *Imbalances*, which require *monitoring* and *policy action*;
- Imbalances, which require monitoring and *decisive* policy action;
- Imbalances, which require *specific* monitoring and decisive policy action;
- *Excessive imbalances*, which require specific monitoring and decisive policy action;
- Excessive imbalances, which require decisive policy action and the *activation of the Excessive Imbalance Procedure*.

In 2015, in-depth reviews were performed for 16 Member States. Six of them (Belgium, Finland, the Netherlands, Romania, the UK and Sweden) were classified in Stage 2; two (Germany and Hungary) in Stage 3; three (Ireland, Spain and Slovenia) in Stage 4; five (Bulgaria, Croatia, France, Italy and Portugal) in Stage 5. None had been placed in Stage 6, which triggers the corrective arm of the MIP. Under this corrective arm, the Member State concerned will have to submit a corrective action plan. Failure to implement a sufficiently corrective action plan may result in sanctions being taken with reverse qualified majority voting.

The scoreboard is the annual starting point of the Commission’s analysis; yet, it is a dense set of indicators (11 headline indicators and 29 secondary ones) that is poorly suited to warning the Council of macroeconomic imbalances. For example, the real effective exchange-rate is computed relative to 41 industrial countries, most of which do not belong to the Eurozone: this binds the indicator to the evolution of the euro, which is outside the control of governments. Similarly, because unit labour costs are given in nominal terms, this measure will vary with inflation, which itself can vary widely across time periods.

<sup>a</sup> The Pact originally defined as “exceptional and temporary circumstances” a year in which GDP fell by at least 2%, with a possible margin of appreciation for ministers if the drop fell between 0.75 and 2% for the year.

<sup>b</sup> Commission Communication: Making the Best Use of the Flexibility Within the Existing Rules of the Stability and Growth Pact, 13 January 2015.

<sup>c</sup> See [ec.europa.eu/economy\\_finance/economic\\_governance/macroecomic\\_imbalance\\_procedure/index\\_en.htm](http://ec.europa.eu/economy_finance/economic_governance/macroecomic_imbalance_procedure/index_en.htm)

In the short term, there is no need to change the instruments, and even less so the rules, to move forward on these three avenues; we propose instead that the European Semester be restructured as shown in Figure 4.

### Better integrated surveillance between the Eurozone level and the national level

To better integrate the two levels of macroeconomic surveillance (Eurozone level and Member States level), we suggest dividing the European “semester” into two successive “trimesters” and to articulate them around three key chapters for short and medium-term monitoring: fiscal policy, competitiveness policies and macro-prudential policy.

The first “trimester” (November of year  $n - 1$  to February of year  $n$ ) would be devoted to assessing the Eurozone situation. It would start with the Council and the European Parliament<sup>26</sup> reviewing a single document (AGS+) focused on the macroeconomic situation of the euro area and its key imbalances with cross-country heterogeneity whenever meaningful. The issue of impediments to long-term growth, however fundamental it may be, would not be dealt with here. Three chapters would be covered:

- Fiscal policy (sustainability, but also fiscal stance with regard to the business cycle);
- Competitiveness policies (changes in unit labour costs, in the share of tradable sectors in value added...);
- Macro-prudential policies (credit growth, debts, real-estate prices... in relation to both financial stability and the business cycle).

The Commission would simultaneously draw up a list of countries for which an in-depth review is warranted under the MIP, on the basis of a simplified alert mechanism (see below). The Council would then vote, after seeking the opinion of the European Parliament, on a recommendation concerning the euro area (including the desirable aggregate fiscal stance) and on a list of in-depth reviews to be carried out.

**Recommendation 1.** Start the European Semester by assessing Eurozone macroeconomic imbalances at the aggregate level and by pointing out cross-country heterogeneity whenever meaningful. This assessment covers three major topics: fiscal policy, competitiveness and macro-prudential policy. After the European Parliament has given its opinion, the Council decides on recommendations for the euro area (including its fiscal stance) and on the list of countries to come under “in-depth” review.

The second “trimester” (March to July of year  $n$ ) would be devoted to assessing Member States. It would start with a review of country reports that would include a section on the MIP’s in-depth review whenever warranted. The country reports should cover the same three chapters as the AGS+ report: fiscal, competitiveness, and macro-prudential policies. Both Stability Programmes and National Reform Programmes prepared by Member States should include a section responding to the Commission on each of these three chapters. The trimester would end with the Country Specific Recommendations (CSRs), which should also be required to cover these three topics. The CSRs should set intermediate goals (such as needed adjustments to unit labour costs) rather than specific measures (minimum wage, social security contributions...).<sup>27</sup> The assessment on draft budgetary plans (November) must be consistent with the country specific recommendations (May).

**Recommendation 2.** In a second phase, finance ministers discuss country-specific imbalances with regard to the three chapters mentioned, based on the Commission’s country reports and taking into account the recommendations adopted for the euro area. Stability Programmes, National Reform Programmes, but also the country specific recommendations all need to explicitly cover these three chapters; they must also aim for intermediate goals rather than specific measures.

In this context, an assessment of fiscal policy would give it back its full macroeconomic stabilisation purpose. SGP rules may temporarily and for some countries constrain this policy; this constraint should be taken into account when expressing the desirable stance of other Member States’ fiscal policy. Our recommendation also highlights the role of macro-prudential policies not only for financial stability, but also for demand management. Price and wage evolutions would also be at the core of the analysis.

### A clearer dividing line between the short or medium-term and the long-term

As noted, the Macroeconomic Imbalance Procedure (MIP) is hindered by the fact that it has no precisely defined objectives and instruments. With the MIP taking place within the ECOFIN Council, it is rational that only instruments in the hands of finance ministers, or at least ones that are not too far from their reach, be considered. For example, short and medium-term monitoring of competitiveness should focus on the evolu-

<sup>26</sup> Ideally, as a Eurozone grouping. However, having elected representatives from non-euro countries work within the Economics and Monetary Affairs Committee of the European Parliament does not strike us as hindering the implementation of our recommendations.

<sup>27</sup> It is likely that simultaneously discussing three topics will facilitate coordination, as each country should find it easier to offer something in return for what it is asking from its partners.

tion of prices, wages and levies rather than on innovation and education issues, which form part of the long-term strategy.<sup>28</sup>

The MIP should be refocused on a small number of issues and instruments; this would lend it greater weight and tie it closer to the SGP. Ideas for long-term growth reforms could still be included in the various documents relating to Member States (Annual Country Report, National Reform Programs, and Country Specific Recommendations). It would however be helpful for them to come under a separate heading within the Europe 2020 growth strategy; it would also be beneficial for these potential reforms to be discussed in another context than that of the ECOFIN Council –for example by the ministers for economic affairs, industry, or energy.

The dividing line between the short and medium-term and the long-term could take the form of a country-specific assumption on potential growth to be set annually. As noted above, figures for both potential growth and future inflation can be revised upwards or downwards by the Commission in its autumn forecast; this then alters the fiscal effort required of countries undertaking structural adjustments, at a time when the budget for the following year is mostly settled. We propose that assumptions for both potential growth and inflation for year  $n$  be fixed permanently at the time of the spring forecasts of year  $n - 1$ . Revising potential growth assumptions in the autumn forecast of year  $n - 1$  would only impact the budget of year  $n + 1$ . The concept of potential growth is a long-term concept which cannot be revised several times a year.

**Recommendation 3.** Refocus the Macroeconomic Imbalance Procedure on short and medium-term objectives. Freeze potential growth and inflation forecasts, which underline the structural adjustment of year  $n$ , at the level given by the spring forecast of year  $n - 1$ .

### Greater awareness and ownership

The two amendments to the semester presented above –sequential examination of the Eurozone and then of Member States, and a clearer dividing line between the short and medium-term and the long-term– are already likely to help Member States make better use of the recommendations made at European level. To go further, it would be helpful for the main European documents relating to a Member State (Annual Country Report, In-depth Review, specific recommendation) to be systematically discussed by the Parliament

of said Member State, and for a hearing of the Commissioner for Economic and Financial Affairs (ECFIN) or of his representative to be held at least once a year.

**Recommendation 4.** Systematise within each national Parliament, the debate on the key country-specific documents published by the European Commission, together with at least one hearing per year of the ECFIN Commissioner or his representative.

We also recommend involving Member States early on in the process by feeding the analytical contribution of three networks of independent committees to the AGS+ report (see Fig. 4). National expertise would then be taken into account upstream of the European Semester and would provide a useful complement to the Commission's analysis.

### Fiscal policy

A noteworthy contribution of the Fiscal Treaty was to establish an independent fiscal council in each Member State. This council is tasked with giving its opinion on the growth assumptions underlying each budget as well as on the evolution of the deficit with regard to the SGP legislation. Aside from an auditing mandate, fiscal committees could also provide an independent assessment of the fiscal stance and these assessments then consolidated at Eurozone level.

A network of independent fiscal committees already exists with EUNIFI (European Union Network of Independent Fiscal Institutions). It met in November 2013 and November 2014 in Brussels, at the invitation of DG ECFIN. The idea here is to strengthen the role of this independent network, as well as to ensure it coordinates well with the Commission.<sup>29</sup>

**Recommendation 5.** Strengthen and coordinate national independent expertise on the evolution of national fiscal policies with regard to debt sustainability and Eurozone stabilisation needs. A summary report, published in September, would provide input for the Commission's analysis on the macroeconomic situation of the euro area. Its main authors would be heard by the European Parliament.

<sup>28</sup> For example, the 2014 recommendation to France under the MIP encouraged the French government to simplify and improve the efficiency of innovation policy and to strengthen electricity and gas interconnection with Spain. While these structural issues may well be very important to long-term growth prospects, they can be difficult to relate to short-term demand management, drifting of costs, and financial risks.

<sup>29</sup> This proposal is close to that of Eyraud and Wu (2015) who see this network as a « discussion partner » of the European Commission. See Eyraud L. and T. Wu (2015): « Playing by the Rules: Reforming Fiscal Governance in Europe », *IMF Working Paper*, no 2015-67, March, and also the report of Pervenche Berès (2015): *Draft Report on the Economic Governance Framework: Stocktaking and Challenges*, no 2014/2145 (INI), European Parliament.

## Macro-prudential policy

In terms of macro-prudential policy, national authorities already coordinate *via* the European Systemic Risk Board (ESRB), which publishes a report in July of each year. To bring greater consensus to national and European-level views, it would be helpful to hold preliminary discussions of the report with the national committees for macro-prudential supervision (in France, the *Haut Conseil de Stabilité Financière*). This would ensure both sides have a better grasp of the analytical work at hand.

**Recommendation 6.** Strengthen the interactions of national expertise on macro-prudential policy to produce a European-level diagnosis. The annual report of the European Systemic Risk Board would be published following this dialogue and at the beginning of the European semester; it would provide input for the Commission's report on the macroeconomic situation of the euro area. Its main authors would be heard by the European Parliament.

## Competitiveness and social dialogue

Some countries have put in place independent advisory committees on wage developments. In France, an expert panel publishes an annual recommendations on whether or not the minimum wage be increased beyond indexation rules. In Belgium, an independent institution publishes a regular report on the evolution of the country's competitiveness relative to Germany, France and the Netherlands, and sets a norm for wage developments in the negotiations between the social partners – a norm that the government has the power to impose to said social partners.<sup>30</sup>

As noted above, remuneration policies in their broadest sense (including social security contributions) entail strong externalities between Member States: they determine the long-term sustainability of countries' Eurozone membership, and they influence short-term price developments throughout the euro area. It would be wise to see each Member State set up the same type of independent committee and to coordinate them at Eurozone level in order to produce an annual report that would kick-start the European Semester. This report would compare the evolution of unit labour costs and the impact of Member States' policies on Eurozone competitiveness and aggregate inflation. This would entail better coordination of fiscal devaluations between Member States for example.<sup>31</sup>

**Recommendation 7.** Establish an independent council for Competitiveness and Social Dialogue at Member State level. This council is tasked with making recommendations on national wage developments and/or sectorial developments, as well as coordinating with peers on producing a consolidated expertise at Eurozone level. A yearly summary report is published at the beginning of the European Semester. Its main authors are heard by the European Parliament.

The French case provides a good example of how interconnected competitiveness and macro-prudential matters really are. France witnessed a decline in its current account, a relative increase of wages in its non-tradable sector, and an increase in its property prices. Although it is never easy to establish causality beyond doubt, it remains very likely that the rise in real-estate prices led to an increase in both wage demands and debt levels. Rising international debt levels helped hide these divergent dynamics. Both competitiveness (wage dynamics) and macro-prudential matters (dynamic of property prices, current account) can thus be seen to be closely interconnected.

The contribution of independent councils to the yearly shaping of a shared Eurozone diagnosis leads us to believe that these mechanisms would make it easier, downstream of the semester, for Member States to grasp and make full use of the Commission's recommendations.

### Simplifying the alert mechanism

In return, the Commission's alert mechanism could be simplified. The Council would be granted the possibility to request in-depth review of any country whose current account balance exceeds a threshold set in absolute value (e.g. 4 or 5% of GDP). The Commission could also recommend an in-depth review be carried out for a selection of other countries, based on reports received from the independent committees and on its own internal judgement, and justifying its choices with the indicators it deems appropriate.

Policy awareness would be raised if the MIP could offer a flagship indicator, in much the same way as the deficit threshold of 3% of GDP plays an important role in governments internalising the constraints that arise from sharing a currency. Replacing the scoreboard with the analytical work of the three networks of independent committees and with the Commission's own expertise would entail little to no loss of information.

<sup>30</sup> See Sapir A. and G. Wolff (2015): « Euro-Area Governance: What to Reform and How to Do It », *Bruegel Policy Brief*, no 015/01.

<sup>31</sup> Fiscal devaluation means lowering the tax burden on labour while increasing VAT rates, in a bid to raise cost-competitiveness. For Eurozone countries, this is a zero-sum game.

**Recommendation 8.** Simplify the analysis of macroeconomic imbalances by highlighting a flagship indicator: the ratio of the absolute value of the current account balance to GDP. Breaching this threshold (e.g. 4 or 5%) automatically warrants an in-depth review. The Commission can nevertheless recommend a detailed analysis be carried out even when this threshold has not been breached, as long as it justifies its choice on the basis of explicit indicators.

## Conclusion: towards further integration

A monetary union requires its member countries to closely coordinate their economic policies. So far, this coordination has focused on fiscal policies, even though externalities arise just as often under competitiveness and macro-prudential policies. To improve the Eurozone's macroeconomic policy stance, particularly throughout the business cycle, we recommend restructuring the European Semester using focused instruments and better articulating Eurozone and Member States levels. The tools and expertise exist. The challenge is to make better use of them.

However, the coordination of economic policies in Europe should be seen only as a step towards greater integration between Member States, especially on fiscal matters. Monetary coordination in Europe survived the 1992-1993 crisis only insofar as a single currency was being introduced. History is repeating itself for fiscal policy; one day, it will have to switch from the "fiscal snake" (coordination rules) to establishing a significant federal budget.

The euro area is gradually developing federal instruments to rescue countries in crisis (European Stability Mechanism), to provide a backstop to the banking union (resolution fund), to supplement the lack of investment by Member States (European Investment Bank). These developments are no mere coincidence.

The idea of a Eurozone "fiscal capacity" was raised in 2012 with the first report of the so-called "four presidents".<sup>32</sup> It considered a system of "limited" macroeconomic insurance: a country subject to a specific negative shock would receive temporary transfers, while a country subject to a specific positive shock would pay temporary transfers.

A Eurozone budget could follow a number of objectives. The first was suggested by the report of the four presidents and consists of a mutual insurance system that would require no debt capacity in the euro area, and therefore no own resource. However, a debt capacity –and therefore own resource– should be developed in order to respond to common shocks, especially since the EU budget will likely be limited in size (about 2% of the euro area's GDP).<sup>33</sup> Finally, the Eurozone budget could also potentially invest in projects of mutual interest so as to raise the area's growth potential or facilitate the energy transition. A federal country combines these three goals (mutual insurance, countercyclical capacity, investment capacity) thanks to its substantial common budget (22% of GDP in the US). A budget of a smaller order of magnitude will probably not offer this possibility.

Further integration will also be needed in areas such as taxation or the labour market. The recommendations proposed in this *Note* should therefore be read as initial steps on the road to further integration, which will progressively appear essential to the success of the economic and monetary union; coordination as a foreshadowing of integration. ●

<sup>32</sup> Rompuy H., J.M. Barroso, J.C. Juncker and M. Draghi (2012): *Towards a Genuine Economic and Monetary Union*, 5 December.

<sup>33</sup> See Pisani-Ferry J., E. Vihriälä and G. Wolff (2013): « Options for a Euro-Area Fiscal Capacity », *Bruegel Policy Contribution*, no 2013/01.



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