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IN-DEPTH ANALYSIS

Economic policy coordination in the euro area under the European Semester

External authors: Klaus-Jürgen Gern
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Kiel Institute for the World Economy

Provided at the request of the
Economic and Monetary Affairs Committee

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November 2015
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Abstract

After three years of mixed operational experiences, the European Semester has been streamlined and further reform has recently been suggested by the European Commission. We outline the major modifications and evaluate to what extent this streamlining has affected the nature of the 2015 country-specific recommendations. Any mechanism for policy coordination depends crucially on the institutional framework that it is supposed to operate in. Consequently, proposals for further improvement of the European Semester must take the institutional environment into account. We therefore work out the compatibility of different aspects of policy coordination with respect to the existing EU architecture and discuss the proposals to modify this architecture put forward recently in the Five Presidents Report. On this basis, we develop proposals for improving the efficiency of the European Semester.

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LIST OF ABBREVIATIONS

EMU European Monetary Union
EU European Union
GDP Gross domestic Product
MIP Macroeconomic Imbalance Procedure
SGP Stability and Growth Pact

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EXECUTIVE SUMMARY

- After three years of mixed operational experience, the European Commission has implemented a number of modifications to the European Semester in order to achieve a more consistent policy agenda with respect to the main challenges, better implementation of recommendations, and a higher level of ownership.

- Improved communication between the Commission and national authorities and stakeholders at the national level, including parliaments, is an important tool to increase the level of ownership as insight requires understanding and transparency supports acceptance. More transparency and updated information on the process and status of implementation of country-specific recommendations would increase peer-pressure and facilitate implementation of appropriate policies.

- The focus on a limited number of priority areas has successfully reduced the number of recommendations. This comes, however, at the cost of dropping recommendations despite limited progress in their implementation, which may give the wrong signals. In the future, balancing continuity and variation in the focus of recommendations will be a challenge.

- The European Semester operates in a complex institutional environment that creates several trade-offs for the implementation of intra-EMU policy coordination (subsidiarity vs. policy coordination, soft vs. strict enforcement mechanisms, short-run vs. long-run requirements).

- The principle of subsidiarity, a key pillar of the European architecture introduced to make full use of the advantages of diversity within the EU, suggests shifting competences to the lowest possible government level. By its very nature, policy coordination works in the opposite direction. No conflicts arise, however, if intra-EMU policy coordination addresses the well-functioning of the euro area as a whole (common interest). Therefore, the Commission should identify areas that are particularly relevant for the functioning of the EMU as a whole and communicate in the most transparent way, whether specific recommendations address the common interest or the national interest of a single Member State.

- While soft forms of coordination (such as peer reviewing, dialogue with national authorities, and communication to the public) come at the cost of relatively weak implementation rates, stricter enforcement mechanisms (rule-based approaches triggering automatic sanctions) are also problematic as optimal rules, indicators, and thresholds vary across countries such that he resulting recommendations would be notoriously sub-optimal.

- The need for operational policy coordination within the European Semester depends on the institutional framework of the EMU, in particular with respect to the stability of the financial sector and the fiscal soundness of the Member States. As long as the risk of negative cross-country spill-overs emerging from these sources persists, the European Semester may have to address policy areas (short- and medium-run) that will lose relevance once these destabilizing factors will be successfully contained (long-run). The less the institutional framework reduces systemic risks that threaten the proper functioning of the EMU as a whole or the more risk-sharing mechanisms (safety nets, EMU-wide macroeconomic shock absorbers) are implemented, the more policy coordination and surveillance is necessary. Prioritising the prevention of excessive risk-taking in the first place rather than creating risk-sharing mechanisms would avoid this. Thus, the EMU should strive for becoming the world's most financially robust, market-oriented economic area.

- In an ideal institutional framework, the European Semester could focus on surveillance, peer reviewing, and strengthening the capacities of national authorities to conduct structural reforms. The existing soft enforcement mechanisms, such as peer-reviewing, dialogue with governments, and communication to the public, should be further strengthened. Such a strategy would be consistent

with the principle of subsidiarity and would be sufficient from a community perspective as misconduct of policies in one country would not put at risk the functioning of EMU as a whole.

- In the currently prevailing institutional framework, the European Semester should also address the prevention of systemic events that threaten the functioning of the EMU as a whole. The financial sphere remains the most important source of negative cross-border spill-overs. Given the high costs of financial crises, it is imperative to increase the implementation rate of appropriate recommendations in the short to medium term. This calls for strict enforcement mechanisms that are based on rules and automatic sanctions. In particular, debt sustainability could be increased by applying the existing rules of the Stability and Growth Pact more rigorously.

- In principle, the MIP is an appropriate tool for the surveillance of financial stability from a macroeconomic perspective. It should be unbundled from other areas, such as growth targets or labour market performance. This would also strengthen the transparency of the European Semester as a whole by reducing overlaps and multi-target instruments. The Scoreboard of the MIP should focus more strictly on indicators that are relevant for financial stability from a macroeconomic perspective. It should be complemented with economically more meaningful indicators in particular with indicators that cover potential investment and capital stock distortions.

- The transparency of the European Semester could be strengthened by being more explicit on the theoretical foundations on which recommendations are based. In particular, strong efforts should be made to elaborate a coherent theoretical framework for those events that threaten the functioning of the EMU as a whole. A common understanding is crucial for creating ownership for policy initiatives that are supposed to address common interests shared by all Member States.

1. INTRODUCTION[1]

The European Semester is a regime for economic policy guidance and surveillance at EU level that has been in operation since 2011. It was created in response to the failure to achieve the pivotal target fixed in the Lisbon agenda of the year 2000, which aimed at making the European Union "*the most competitive and dynamic knowledge-based economy in the world*" (European Council 2000). Important goals to be reached by 2010 such as increasing the employment ratio to 70 percent, raising R&D expenditures from 1.8 percent to 3 percent of GDP, or achieving average GDP growth of 3 percent were missed by a large margin. Insufficiently consistent national economic policies and a lack of coordination were identified as the key causes of the disappointing outcome.

The introduction of the European Semester was finally triggered by the European sovereign debt crisis, which was seen as further evidence that more cooperation and surveillance was needed in particular within the euro area. In order to fill the perceived gap and to raise the prospects for the successful realization of the goals laid down in the follow-up long-term strategy "Europe 2020" (aiming at smart, sustainable, and integrative growth), the European Semester was initiated. It is also instrumental for macroeconomic surveillance as postulated in the Stability and Growth Pact (SGP) and the Macroeconomic Imbalances Procedure (MIP).

After three years of mixed operational experiences, the European Semester has been streamlined. We outline the major modifications in chapter 2 and evaluate to what extent this streamlining has affected the nature of the country-specific recommendations (chapter 3). Any mechanism for policy coordination depends crucially on the institutional framework that it is supposed to operate in. Consequently, proposals for further improving the European Semester must take this framework and emerging future modifications thereof into account. In chapter 4, we therefore work out the compatibility of different aspects of policy coordination with respect to the existing EU architecture and the far-reaching proposals to modify this architecture put forward recently in the Five Presidents Report. Based on the results from the preceding analysis, we develop proposals for improving the efficiency of the European Semester (chapter 5).

While the European Semester applies to all EU Member States, this analysis focuses on the relevant aspects for policy coordination within the European Monetary Union (EMU). As policy coordination is a very broad concept, we use four categories for differentiation. Category 1 covers all forms of information sharing among Member States (in particular, peer reviewing and best-practice exchange), category 2 refers to those forms of policy coordination where a policy decision in country A is made dependent *ex ante* on policy decisions in other countries (e.g., using fiscal space in country A to stimulate economic activity in country B). Category 3 implies running similar polices in all Member States (harmonization) and, finally, category 4 represents centralized policy-making at EMU level (shifting competences from the national level to EMU institutions). We further distinguish between soft and strict forms of policy coordination. While soft forms are of a non-binding nature and based on insight and consensus finding, strict forms come with enforcement mechanisms that imply some type of legal sanctions. Typically, policy coordination of category 1 draws heavily on soft forms of enforcement while category 4 implies strict enforcement mechanisms. In categories 2 and 3 both forms of enforcement are conceivable.

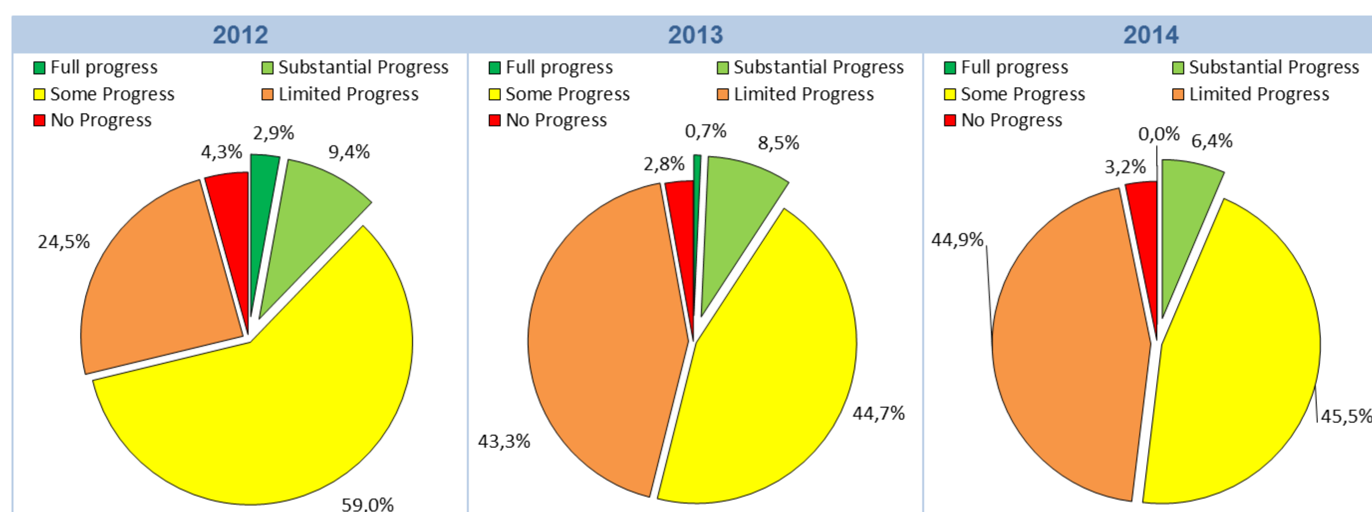
[1] The authors thank Esther Ademmer, Niklas Drews, Jens Boysen-Hogrefe, and Ulrich Stolzenburg for highly appreciated comments and discussions.

2. THE STREAMLINED EUROPEAN SEMESTER AND THE QUEST FOR OWNERSHIP

The European Semester is the revolving annual cycle of economic budgetary coordination starting from the Annual Growth Survey and culminating in country-specific recommendations to address identified major challenges. The Annual Growth Survey (published in November/December of the preceding year) in tandem with the Alert Mechanism Report of the MIP represent the starting point of the European Semester. During the winter months, country reviews are compiled by the Commission containing an analysis of macroeconomic backdrops and an in-depth analysis of country-specific cyclical and structural problems for each Member State. In March, the European Council adopts guidelines for directions of national policies before, in April, national governments present their policies for sound public finances (in the stability programmes or convergence programmes, respectively) and outlines their reforms and measures to make progress in the direction of the Europe 2020 goals (in the national reform programmes). Usually in May or June, the Commission drafts country-specific recommendations proposing economic policy measures for each Member State, depending on the country's economic and social performance in the previous year. The recommendations are based on the results of the country reports and reflect the priorities set out in the Annual Growth Survey. They are adopted in July by the European Council.

After three years of mixed operational experience, the European Semester has been significantly streamlined. In 2015, the Commission has implemented a number of modifications in order to achieve a more consistent policy agenda with respect to the main challenges, a better implementation of recommendations, and a higher level of ownership. Implementation has been disappointing in recent years. In 2012–2014, only around 10 percent of recommendations have been fully or substantially put into legislation, meaning that Member States have adopted and implemented measures that are appropriate or go a long way in addressing the country-specific recommendations. At the same time, the share of recommendations which have been insufficiently addressed, where adoption or implementation is at risk or no measures have been announced or adopted at all (limited or no progress in implementation) has risen from 29 percent in 2012 to 46 percent in 2013 and 48 percent in 2014 (Figure 1).

Figure 1: Implementation of country-specific recommendations by EU Member States, 2012–2014



Source: European Parliament (2014, 2015a), 2012: own compilation of European Commission assessments published in Commission Staff Documents available on the "Europe 2020" webpage http://ec.europa.eu/europe2020/making-it-happen/country-specific-recommendations/2013/index_en.htm.

The streamlined European Semester includes focusing on the top priority areas in each Member State, earlier publication of the country-specific and euro area analysis underpinning the

recommendations (in January rather than in March/April), and a more intensive outreach at the political level. Focusing on the key challenges as identified in the Annual Growth Survey implies a smaller number of recommendations, which has been appreciated by national governments. A more limited number of recommendations may lead to stronger compliance efforts as political capital is limited. It may, however, be a problematic signal if recommendations that have been listed in one year drop out of the list in the next year despite little or no effort to implement policies designed to improve the situation, just because the focus in the Annual Growth Survey has shifted. With the streamlined European Semester, the in-depth reviews prepared in the MIP context for countries that merit closer monitoring are now integrated into the regular country reports. While this procedure may look straightforward, it risks reducing the focus on key stability issues, which would be particularly dangerous in terms of economic developments with community-wide implications.

Ownership creation for policy recommendations remains the most critical success factor. As research related to IMF adjustment programmes suggests (Bird and Willett 2004, Dreher 2008, Khan and Sharam 2001), the level of "ownership" (i.e., the insight into the reasonableness of reform proposals by those in charge of implementing them) is the most critical element for the success of any structural reform agenda. Thus, any modification of the European Semester should be primarily judged by the extent to which it contributes to improving this condition *sine qua non*.

Involving national parliaments in the European Semester can help improve ownership and should be strengthened. In the current procedure, national parliaments of Member States should participate in the preparation of Stability and Convergence Programmes and National Reform Programmes in order to increase transparency and ownership of the decisions taken, and the programmes should inform about whether and how the parliaments were involved. A survey by the European Parliament (2015b) finds, however, that only half of the 2015 programmes delivered the required information.[2] The Commission should strengthen surveillance of this element of the European Semester and specify which form the participation of the parliament at least should have. It should require Member States to report a schedule for involvement of the parliament that should be publicly available.

Communication can play an important role for raising compliance with the country-specific recommendations finally endorsed by the European Council. Improved communication between the Commission and national authorities and stakeholders at the national level is an important tool to increase the level of ownership as insight requires understanding and transparency supports acceptance. The early presentation of an integrated country analysis facilitates more intense discussions with government officials, political party representatives, social partners, non-governmental organizations as well as academics and is intended to ultimately lead to a better understanding in the broad public.

More transparency and current information on the process and status of implementation of country-specific recommendations would increase peer-pressure and facilitate implementation of appropriate policies. Member countries should be required to submit an agenda outlining steps and milestones on the way to implementation of measures addressing the country-specific recommendations, which should be available to the public and could be monitored by Commission and/or European parliament. Failure to address recommendations appropriately or achieve milestones should be explained on a regular basis. The new format of country-specific recommendations with a smaller number of recommendations is conducive to such an exercise.

[2] Involvement of the national parliaments can take several forms: Information, discussion or approval. Stability/Convergence Programmes and National Reform Programmes should explicitly state whether and in what form national parliaments have been involved. Only 27 of the 54 of the 2015 vintage make the required reference.

3. THE 2015 COUNTRY-SPECIFIC RECOMMENDATIONS

The 2015 European Semester focuses on investment, structural reforms, and fiscal responsibility. In the streamlined European Semester, the country-specific recommendations are supposed to reflect the focus of the Annual Growth Survey. The Commission identifies three priority areas for action in its 2015 Annual Growth Survey that mutually reinforce one another ("three pillar approach"): A coordinated **boost for investment** with the establishment of the Investment Plan for Europe as a central element; renewed commitment to **structural reforms** including administrative reforms to improve the business climate; and pursuing **fiscal responsibility,** not only by keeping deficits and debt levels under control in accordance with European rules, but also by improving the quality of public finance. As a consequence of the concept of the streamlined European Semester, in its 2015 country-specific recommendations, the Commission is to focus on recommendations addressing these challenges. In its presentation of the country-specific recommendations, however, the Commission explicitly introduces a fourth area of focus, namely improving **employment policy and social protection,** which in the Annual Growth Survey is included under the label of structural reforms.

The three pillars of the Annual Growth Survey still cover a broad range of issues to be potentially addressed in the country-specific recommendations. Concerning investment, there are a number of relevant policy areas, including barriers to financing and launching of investment projects (credit availability and capital market access, especially for small and medium-sized companies, administrative red tape and corruption) and issues directly related to the implementation of the Investment Plan for Europe.[3] Concerning structural reforms in product, service and labour markets, they can contribute to productivity and investment and ultimately boost prosperity by fostering growth and employment. Streamlining the public administration and judicial systems are instrumental for improving the business climate and incentives for investment. Reforms geared at improving the functioning of the financial sector could ease access to finance for investment without jeopardizing the necessary deleveraging in the economy. Concerning fiscal policy, a key element is the continuation of fiscal consolidation, especially in those countries that still have to go a long way to meeting the medium-term target of a structural general government balance close to zero. However, against the backdrop of significant improvements in the fiscal positions of most European countries in recent years and a declining number of countries in the excessive deficit procedure, the Commission now sees the need to strike a balance between short-term stabilization and long-term sustainability and advocates an increasingly flexible interpretation of the rules of the Stability and Growth Pact (European Commission 2015). In addition, improving the structure of revenues and expenditures remains a possibility for fiscal authorities to positively impact on growth.

The limited number of priority areas has successfully reduced the number of recommendations and sharpened its focus. The total number of recommendations has been reduced from 165 in 2014 to 106 in 2015 (including 4 recommendations in each year for the euro area as a whole). The average number of recommendations is now four, down from six in the previous year. At the same time, the individual recommendation tends to have a stronger focus. In previous years, some recommendations were "mixed bags" of issues, examples being the 2014 recommendation 6 for the Czech Republic ("accelerate reform of regulated professions … and improve energy efficiency in the economy") or Portugal ("improve evaluation of the housing market … remove remaining restrictions in the professional services sector … Eliminate payment delays by the public sector "). In 2015, recommendations are generally much more targeted. In this respect, however, the approach was not uniform across all countries. While in some cases, one complex recommendation that dealt with a diversity of fiscal issues (fiscal balance in general and issues related to the tax system, the pension system and/or the health care system) was split into two (e.g. France) or even three (Czech Republic) different recommendations, in other cases recommendations on healthcare or pension reform were merged with a recommendation on the general fiscal stance (Bulgaria).

[3] Interestingly, only one recommendation explicitly features the Investment Plan for Europe.

The nature of the country-specific recommendations has generally changed in the direction of setting objectives rather than devising means. In 2015, the country-specific recommendations have not only been reduced in number but also in terms of detail and complexity, albeit with some exceptions. The recommendations are now generally much shorter, limited to one central aspect, and suggest general objectives rather than specific measures to achieve it. This strategy is a two-edged sword. On the one hand, ownership could rise by setting the goals at the European level (in close cooperation with national representatives in the course of mutual debate during the European Semester) and leaving it to the Member States to make the necessary commitments to concrete implementation measures. On the other hand, a more general level of recommendations complicates monitoring and makes it easier for governments to evade implementing appropriate action. There is also the problem that quantitative variables tend to lose their relevance as soon as they are made a policy target (Goodhart's law).

Dropping recommendations despite limited progress in their implementation may give the wrong signals. In many cases, in fact in most of them, recommendations to take policy initiatives in areas that are not in the current focus of the Annual Growth Survey have been eliminated, although their degree of implementation has been less than substantial. Out of the 41 recommendations from the year 2014 that did not make it in one form or another into the 2015 recommendations, only 2 had been implemented to a substantial degree (completion of the ECB's asset quality review in Croatia and reform of state owned enterprises in Lithuania). Although the Commission stresses in its communication that this does not indicate that those areas have lost importance, it may wrongly signal that reduced effort may be acceptable. Policy areas that have been featured in previous years' recommendations and that were (almost completely) left out in this year's edition include educational and environmental issues. Another central strategy of the commission reflected in the recommendations in recent years was to advocate a shift in taxation from direct taxes to indirect taxes and environmental taxes. Despite only moderate implementation, this topic has almost disappeared this year.

The criteria for the selection of recommendations are unclear. Despite the communication of the Commission explaining the new approach of focusing on specific areas (although still broadly defined), questions with respect to the selection of the recommendations remain. A case in point is the treatment of social policy and labour market issues. While in some countries recommendations related to labour market policies (Ireland, Netherlands), youth unemployment strategies and social inclusion plans (Luxembourg, Spain) or effectiveness of social transfer systems (Romania, Lithuania) have been dropped although implementation has so far not been sufficient, in other countries similar recommendations have been kept (Bulgaria, Portugal). Also, recommendations that could easily be related to the Commission's central policy directions have in a number of cases been eliminated despite only modest progress in implementation, especially recommendations concerning administrative reforms, red tape, or tackling corruption, fields in which action would be conducive to investment (Spain, France, Poland, Portugal, Romania, Hungary, Malta). At the same time, in other countries these issues remain on the agenda (Bulgaria, Czech Republic, Croatia, Italy, Latvia, Slovenia, and Slovakia).

Recommendations on the euro area level are mainly directed towards improvement of the coordination framework and progress in deepening the economic and monetary integration. There are four recommendations related to implementation of the broad guidelines for the economic policies of the Member States whose currency is the euro. The recommendations include: (1) the use of peer pressure to promote structural reforms and assessment of the delivery of reforms on a regular basis; (2) coordination of fiscal policies to ensure an appropriate fiscal stance; (3) progress on the way to restoring a healthy financial sector and towards a banking union; (4) suggestions for deepening of EMU and improved governance in the euro area (based on the Five Presidents Report). Those recommendations that relate to the institutional design of EMU (recommendations 3 and 4) and the execution of the European Semester (1) seem appropriate, although progress and monitoring with regard to their implementation are potentially complicated by the fact that it is not completely clear who is the addressee in each case (Commission, Council, European Parliament, Member States). Recommendation 2, however, seems problematic as it refers to a fiscal stance on the euro area level which, by coordination, should be brought

in line with sustainability risks and cyclical conditions. The latter are, however, observed on the country level and macroeconomic stability in the euro area would deteriorate rather than improve if the individual countries' fiscal stance would target European aggregates rather than national conditions.

Issues of particular relevance for the euro area level have lost importance. Especially those policy areas that can be assumed to have the largest international spill-overs and therefore to make the strongest case for cooperation at the EMU level are less visible in this year's recommendations. The most important of these areas would be the financial sector. While there is still a number of recommendations left that deal with financial issues, the focus has shifted from reducing vulnerabilities to restoring normal lending behaviour. Another set of policies with supranational importance would deal with environmental issues, especially greenhouse gas emissions. These are almost completely missing in this year's recommendations. While the reduced presence of recommendations demanding action to safeguard financial stability may be explained by the fact that the economies a few years after a financial crisis generally do not show signs of froth in the financial sector, the absence of environmental issues suggests a limited priority of the 2020 goal of environmental sustainability in times of subdued growth and high unemployment.

Balancing continuity and variation in the focus of recommendations is challenging. On the one hand, the focal areas of the Annual Growth Survey are, although not comprehensive, sufficiently general and difficult to tackle that they can be expected to remain on the agenda for a number of years. On the other hand, important policy areas have been moved out of the spotlight of the country-specific recommendations this year and may need fresh attention in the coming years, or new priorities may arise. It remains to be seen how the Commission is going to deal with the conflicting requirements of following up on one strategy and catering for varying foci without increasing the number of recommendations again.

4. THE INSTITUTIONAL FRAMEWORK IN WHICH THE EUROPEAN SEMESTER OPERATES

The optimal design of the European Semester and its efficiency crucially depend on the institutional framework of the EU and the EMU. In this Section, we discuss general aspects that are relevant for economic policy coordination in the EMU (Section 4.1), comment on the Five Presidents Report that aims to give a roadmap for completing the EMU (Section 4.2), and briefly outline an improved institutional framework and its consequences for the European Semester (Section 4.3).

4.1 General aspects of economic policy coordination in the EMU

Economic policy coordination among EMU Member States should be clearly targeted to the prevention of negative cross-border systemic spill-overs as it may otherwise conflict with the principle of subsidiarity. The principle of subsidiarity, as laid down in Article 5 (3) of the EU Treaty, is a fundamental pillar of the EU architecture. The key aspects of this principle (incentive structure, availability of information, access to adequate instruments, democratic legitimacy) put strong emphasis on shifting competences and responsibilities to the lowest possible governmental level, with the market process (private coordination) marking the bottom end. Given the high importance of this principle, any divergence from it should be explicitly justified by the common interest of all Member States. Systemic external effects that harm the functioning of the monetary union affect this common interest and would therefore be a case for regulating national policies at EMU level. These detrimental cross-border spill-overs must not be confused with pecuniary "external" effects that simply reflect well-functioning mechanisms of the single market. Economic performance losses due to badly designed policies in one country would therefore have to be accepted as long as the consequences mainly affect the respective member country and do not harm the stability of the union as a whole.

Subsidiarity implies diversity and thus sets limits for harmonization or centralization at EMU level while simultaneously opening the field for intensive peer reviewing and best-practice exchange within the European Semester. Diversity would be unnecessary if one-size-fits-all regulations existed and if the best approach to policy-making was known or at least generally accepted as a consensus. So far, this is not the case. Thus, allowing for diversity is a basic strategy that benefits all Member States. It makes the community more robust as wrong regulations do not apply to all member countries simultaneously and, even more importantly, it allows for trial-and-error search processes and evolutionary improvements by mutual learning in a world of imperfect and decentral knowledge. The latter makes a strong case for using the European Semester for intensive peer-reviewing and exchange of best-practice experiences. Via learning, all Member States benefit from the experience made by their peers (both positive and negative). This learning mechanism therefore depends crucially on diversity and the capacity of testing new policies by pioneers. However, it should be kept in mind that the knowledge (and thus the consensus) about what might be considered a "best practice" will remain limited. Plus, views on mainstream paradigms typically change over time. Therefore, the economic governance within the EMU must provide for mechanisms that allow for (gradual) paradigm shifts. This requires room for manoeuvre for policy pioneers.

The notion of "competitiveness of countries" is conceptually flawed and may lead to misguided policy recommendations. The concept of competitiveness is central in the European reform debate. While competitiveness is a meaningful concept for companies, it is inappropriate when applied to economic areas or countries (Krugman 1994, 1996). A company must exit the market when its costs persistently exceed its revenues. Because a company in a competitive environment cannot reduce the prices for its inputs (in particular, wages) it will either see its inputs move to competitors or become insolvent right away. By contrast, within the economic system of a country, the price of domestic inputs can adjust. As competition is a relative concept, the notion of "competitiveness" suggests that the problems of one country are at least in part caused by the rest of the world. This view also invites to overemphasize and misinterpret trade balances. International trade is not a zero-sum game but mutually

beneficial for both parties. While competing firms operate on the same side of the market, trade between countries includes both sides, sellers and buyers. Countries do not differ in terms of "competitiveness" but in terms of "productivity" (including regulatory quality), which translates into different income levels. Raising productivity is something to be done at home (or with the help of capital and knowledge imports), but not via economic policy coordination of the category 2-type (i.e. a compensating policy response abroad). With respect to unemployment, again, not the level of competitiveness is decisive but whether wages are in line with productivity which is hardly a matter for international policy coordination.[4]

The theoretical foundations for macroeconomic "imbalances" and "shocks" are insufficiently specified, prone to confusing cause and effect, and too vague to shape the new economic governance structure of the EMU. While the MIP was introduced to prevent macroeconomic imbalances from destabilizing the euro area as a whole, it remains theoretically unclear what exactly should be regarded as an imbalance and what the cause of such imbalances is supposed to be. So far, no satisfying clarification has been reached,[5] and the economic reading of the scoreboard indicators is open to vast interpretations as the debate on the twin-issue of "excessive current account balances" and "wage divergences" illustrates.[6] Similarly ambiguous is the notion of "macroeconomic shocks" that is central in the Five Presidents Report. Most of what is typically classified as a shock is either the reversal of an unsustainable domestic trend (including unsustainable policy stances) or the occurrence of an economically relevant event beyond the reach of national policy makers. The first type of shocks does not simply occur but is deeply rooted in unsustainable incentive structures, most of which can be summarized as a violation of the accountability principle (i.e., the actual or perceived ability to shift risks to third parties resulting in excessive risk-taking). Those shocks are not exogenous to the economic process (very often they build up over time – like excessive debt financing – and materialize only when critical thresholds are reached). What then shows up as a confidence crisis is the consequence of deficiencies in the regulatory framework.[7] The second type of shocks (e.g., abrupt changes in external data like oil prices) can be either temporary or permanent. Non-temporary shocks are structural changes to which the country must adapt anyway. The idea of using the EMU as a macroeconomic insurance facility raises serious questions of mechanism design (prevention of moral hazard, identification of shocks) making it unclear to what extent intra-EMU policy coordination could help alleviate the consequences of such a shock for the EMU as a whole in an intertemporal perspective. Temporary shocks are typically too short-lived to make the European Semester a suitable mechanism to cope with them. To the extent that these shocks affect the national business cycle in the short run, a country with sound public finances and access to capital markets has sufficient domestic instruments available to dampen those destabilizing effects.

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[4] In a functional market framework, wages should respond to the situation in the very same labour market that they are set for, and not with respect to the situation in foreign labour markets. If wages fall due to unemployment in one country (or in the region of one country), this wage response creates a pecuniary "external" effect for the rest of the world, which is the very essence of the market mechanism as it indicates varying scarcities via the price system. As the pressure for falling wages fades away once full employment is re-established, there is no escalating downward spiral of wages in the EMU originating from one Member State. Likewise, even in the case of a closed economy, a country would suffer from unemployment if its labour market regime allowed wages to surpass the level of labour productivity.

[5] EU Regulation 1176/2011 on the prevention and correction of macroeconomic imbalances defines an imbalance as "*any trend giving rise to macroeconomic developments which are adversely affecting, or have the potential adversely to affect, the proper functioning of the economy of a Member State or of the economic and monetary union, or of the Union as a whole*". This describes the symptom, not the cause.

[6] While some economists look at trade flows from a labour market perspective (higher domestic wages translate into higher domestic prices, causing higher imports and lower exports), other economists would stress the importance of capital flows that shift purchasing power from one country to another, increasing nominal demand in the recipient country, which then translates into higher prices and wages (not the other way around), triggering imports and dampening exports (and causing no "lack of aggregate demand" in the recipient country). While the first view would recommend policy makers to intervene in the labour market, the second view would stress potential distortions in the financial sector (like implicit guarantees) and – in the absence of those – would not consider the free flow of capital (and thus current account balances) a problem at all.

[7] E. g., the Greek debt crisis clearly did not come as an external shock to Greece. Given the unsustainable policy setup in the country, a debt crisis would have occurred sooner or later.

Economic convergence is not the prerequisite for but is supported by a well-functioning monetary union within the single market. Fundamentally, a monetary union represents a group of countries that agree on the same universal means of exchange (single currency). The usefulness of money to facilitate the division of labour via indirect exchange does not depend on the relative income positions of the money users. Therefore, a workable monetary union does not depend on similar or converging productivity levels among participating countries; nor do productivity (and income) differentials require compensating fiscal transfer mechanisms in order for the monetary union to operate smoothly. Both market forces and the incentives for policy makers in less productive regions are sufficient to respond to productivity differentials, provided they are reflected in price differentials to stimulate economic activity and attract foreign direct investment. To the extent that productivity differentials are due to poorly performing national policies (institutional framework), peer reviewing and exchange of views during the European Semester (type-1 category of policy coordination) can play an important role for achieving improvement. With regard to monetary policy, convergence in terms of the co-movement of the business cycles (or the output gap) in all Member States would make policy making easier. However, this does not refer to the convergence of productivity levels but to those of output gaps (deviation from normal capacity utilization). While the former is envisaged within the European Semester (in particular with respect to the 2020 goals), the latter hardly fits into this mechanism as business cycle synchronization via policy coordination (type-2 category) would not only raise extremely difficult conceptual questions but would also require a higher frequency of actions.

4.2 The Five Presidents Report

Next to specific proposals for the European Semester the Five Presidents Report provides a set of broad institutional initiatives for economic, financial, fiscal, and political reforms of the EMU framework with a strong emphasis on more policy coordination. While the proposals for the two-stage European Semester (euro area analysis preceding country-specific recommendations) and for two new types of institutions (system of Competitiveness Boards[8] and an advisory European Fiscal Board) would directly affect the operation of the European Semester (in particular with respect to policy coordination of the type-1 category), the broader institutional initiatives would affect the European Semester indirectly (in particular by creating more EMU-wide macroeconomic mechanisms) or remain very vague. The wording ("completing" and "deepening" the EMU or making it "genuine" or "fair") makes it difficult to identify the underlying theoretical concepts. While the report argues that more policy coordination is needed for better economic, financial, fiscal and political performance, no reference is made to the principle of subsidiarity or to other conceptual difficulties that a higher degree of policy coordination may imply.

The European debt crisis revealed severely defective regulations in the financial system that call for much stronger policy coordination. Financial stability is the key prerequisite for the smooth functioning of the monetary union. It is hard to see any systemically relevant negative cross-border spill-over that is not spread crucially via the financial system and the banking system in particular.[9] Therefore, dysfunctional national financial regulations are the most important source of destabilisation of the monetary union. This is due to the debt-backed monetary system that puts the payment systems of the euro area at risk whenever non-performing loans or other mal-investments by banks surpass critical thresholds. A collapse of these systems would severely damage the real economy. Given the cross-border interconnectedness of banks, the common interest is at stake, calling for strong euro area-wide policy coordination of category type-3 or type-4. The regulatory response could follow two fundamental approaches:

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[8] Formerly named Competitiveness Authorities.

[9] Put another way: Once the financial system is robust, the scope for necessary further EMU-specific policy coordination may become very narrow.

- ***Approach 1***
  All participants in the financial system (in particular in the banking sector) become robust or irrelevant enough to such an extent that the failure of one of them would not harm the whole system as a whole (i.e. radically solving the "too-big-to-fail"-problem).
- ***Approach 2***
  Systemically relevant financial institutions may persist but the disturbances that the failure of one of them may cause are absorbed by stronger safety nets and other "shock absorbers".

The Five Presidents Report adopts an approach that is dominated by enhancing macro-management and "shock absorption" at EMU level rather than making the need for "risk sharing" (both public and private) less urgent. By strongly stressing the need for more "risk sharing" within the EMU (both publicly and privately), the approach that the Five Presidents Report adopts clearly points at the aforementioned second approach. Indeed, risk sharing is a suitable instrument to overcome the national re-segmentation of financial markets that disintegrated the euro area and aggravated the financial crisis. As long as implicit bail-out guarantees for systemically relevant financial institutions persist and as long as they depend on the solvency of the sovereign (including bank-sovereign negative feedback loops), there is no level playing field in the EMU banking market. To overcome this, the Five President Report promotes several mechanisms for risk sharing (e.g. a common deposit insurance scheme and a "last-resort financial safety net" as a common backstop to the Banking Union). However, these risk sharing mechanisms are cures for symptoms, not the root causes. They create new room for moral hazard that then has to be mitigated by even stronger supervision, the feasibility of which is extremely demanding if not impossible.[10] The strong focus on macro-management is prone to treat aggregates as if they were decision-making economic agents. But "the financial industry" or "the private sector" does not act. Therefore, shifting risks to "the private sector" by compulsory risk sharing among all agents within the private sector does not address the problem of excessive risk-taking of one agent at the expense of others (unless one assumes that risks can be calculated in a sufficiently exact way by supervisors). While this would shelter the tax payer from dysfunctional transfers to risk takers, other third-party private agents would still be exposed to such risks (money users, credit clients of banks). The alternative approach brings the risk that individual agents take and their individual accountability back in line with each other (i.e. treating the root causes of the "shocks"). This would avoid severe incentive problems and the need for EMU-wide safety nets for the financial sector as "shock absorbers".

More joint liability at EMU level necessarily calls for stricter supervision and narrows the scope of national policy-making. The more risk sharing and shock absorption mechanisms are implemented at the EMU level, the more likely the impact of deficient national policies will also be compensated (i.e. shared among all EMU Member States). To prevent these negative side-effects, stricter supervision would become necessary, dampening the spirit of ownership when it comes to structural reform proposals within the European Semester.

The proposal for a fiscal capacity on the EMU-level (euro area treasury) reflects the dominance of macro-managing rather than curing structural problems. A fiscal capacity for the EMU would call for an economic analysis of EMU-specific collective goods in the first place. While EU-wide public goods can be identified (and should then be reflected in the EU budget), EMU-specific public goods are rare, if they exist at all. Once fiscal soundness of all Member States is re-established, the need for a centralized macroeconomic stabilization mechanism as a further shock-absorber is not required since governments with access to financial markets can play this role themselves. While it may be tempting to allow counter-cyclical fiscal policies via euro area treasury for high indebted countries that face market pressures otherwise, this possibility would reduce the need for consolidation since the ability to conduct

[10] E.g., according to the Five Presidents Report the European Deposit Insurance Scheme is to be "privately funded through *ex ante* risk-based fees" [italics in the original]. This ignores an important lesson from financial crises: the density functions for risk assessments in times of financial crises cannot be calculated *ex ante*.

counter-cyclical policies is a good reason to seek for fiscal space. In consequence, the euro area treasury would make it even harder to reach the goals of the Stability and Growth Pact.

The role for national Competitiveness Boards as proposed in the Five Presidents Report remains questionable. The supervision of wage-setting processes and the responsibility for productivity-enhancing policies are already assumed by established institutions (labour market participants, national ministries of economics, economic research institutes). In particular, both fields do not call for coordination within EMU Member States as there is little that productivity pioneers can do for those who remain behind (except for sharing their institutional experience). The latter must adapt to the former, not the other way around. Also, we reiterate that the term "Competitiveness" has misleading connotations and should be avoided in the context of countries.

Policy recommendations for the euro area as a whole are problematic and may weaken economic policy coordination within the euro area. The Five Presidents Report proposes a higher integration of the euro area and national issues during the European Semester. So far, the euro area has been assessed at the same time as the countries. It has been criticized that this contemporaneous evaluation does not allow for sufficient feedback of the country-specific recommendations with respect to euro area issues (Darvas and Vihriälä 2013). The proposal in the Five Presidents Report suggests stricter sequencing. First, the euro area as a whole is assessed. Afterwards, country reports and country-specific recommendations can respond to the recommendations for the euro area. Recommendations for the euro area as a whole face the problem that there is little policy lever to conduct economic policies at this level, with the ECB being the major exception. However, the European Semester is not designed to impact on monetary policy. The Eurogroup, although it is a forum in which economic developments and policy initiatives can be discussed at the euro area level, has no capacity to actually implement policies, which remains in the domain of the Member States. This obvious deficiency, which makes the monitoring of the euro area very questionable, is planned to be overcome by coordinating country-specific recommendations. In our view, it is unclear why and how economic policy in a specific country should respond to euro area aggregates. Growth-enhancing structural policies and stability-oriented measures are very likely to prevail independently of the situation on the aggregate. Darvas and Vihriälä (2013) make the example that countries with a sound fiscal status should provide more stimulus if the output gap in the euro area is negative. However, using the European Semester for fine-tuning the euro area business cycle via fiscal policy based on uncertain output gap estimates is questionable. The acceptance for the European Semester could be severely damaged if countries were urged to pursue economic policies aiming at some euro area aggregate with presumably negative consequences at the national level. E.g., if a country that has "fiscal space" and that operates at normal capacity utilization levels was recommended to stimulate its economy to reduce a euro area wide negative output gap, then this form of policy coordination would destabilize the respective country. This illustrates a general problem of directing policy instruments (here: national fiscal policy) at more and more comprehensive aggregates (here: euro area wide output gap) as the very purpose of aggregation is to eliminate information on the composition of the aggregates.

4.3 Directions for strengthening the institutional framework of the European Union

Common interests call for strong policy coordination while diversity should prevail in all other policy areas to make mutual learning work. In line with the principle of subsidiarity, the economic governance structure for the EMU should strive to reduce the range of strong policy coordination to a minimum. This minimum is defined by those policies that are required to protect common interests of the community as a whole. Within a monetary union, the stability of the payment systems (provision of money) is the upmost common interest as no other economic sphere is prone to similar cross-border spill-overs whose negative impact on the real economy would be comparably strong. In all other policy areas, diversity within the EMU reflects not weakness, but strength of the European approach. This leaves room for gradual convergence of national policies if best-practices evolve over time.

EMU-wide financial standards that credibly leave risks at the level of individual actors are preferable to public or private risk sharing mechanisms. Any form of risk sharing (both private and public) is prone to create incentives for excessive risk taking that require even more supervision. Thus, establishing the no-bail-out principle in a credible and EMU-wide way (both for sovereigns and for large banks) would clearly be the first-best solution for protecting the common interest of financial stability. This would create a truly level playing field for the banking industry and prevent national segmentation of financial markets that are incompatible with the EMU as single market for financial services. To achieve this, strong policy coordination of the type-3 and type-4 category is necessary to make sure that any financial player in the EMU may exit the market without causing systemically destabilizing effects.[11] As long as some banks are systemically important ("too-big-to-fail"-problem), something is severely wrong within the regulatory framework for the financial system. Thus, the EMU should aspire to become the most robust, truly market-based currency area of the world.

Institutions require consensus, not the other way around. Without consensus on key economic policy issues strong policy coordination cannot work as ownership would not emerge. National policy makers would conflict with their democratic legitimation if they complied with recommendations that they consider (rightly or wrongly) as detrimental to their country. Formal institution building within the EMU is no substitute for consensus finding as viable institutions crucially require the latter. Supporting consensus finding via soft policy coordination (type-1 category) is therefore of upmost importance for any progress to be made in the field of EMU governance structures.

[11] Policy proposals for systematically ring-fencing individual market participants range from imposing significantly higher equity ratios to compulsory Contingent Convertible Bonds. Of course, such a regulatory approach cannot be implemented over night. See Snower et al. (2013) for a reform package that takes the transition process into account.

5. HOW THE EUROPEAN SEMESTER CAN BE MADE MORE EFFICIENT

Based on the preceding analysis, this section presents suggestions for improving the efficiency of the European Semester within the current institutional framework (Section 5.1) and discusses the proposals from the European Commission of 21 October 2015 to take forward Stage 1 (deepening the EMU within the existing rules) of the Five Presidents Report to completing the EMU with regard to the European Semester (Section 5.2).

5.1 Suggestions to improve the efficiency of the European Semester

In the light of recent experience, swift and easy solutions that significantly improve the efficiency of the European Semester are not in sight. When reforming the European Semester, policy-makers should be well aware that such an endeavour will be a slow and continuous process rather than one of swift and significant improvements. As its efficiency crucially depends on the institutional framework (that cannot be changed within the European Semester itself) procedural modifications alone will rarely be a game-changer. In particular, as long as economic policy is – possibly for good reasons – left under the authority of the Member States, the implementation rate of recommendations will remain relatively low whenever they conflict with the aims of national authorities. However, changing this setup is – if it is reasonable at all – a long-term political project towards a more centralized European Union that requires democratic legitimation rather than a question of modifying the European Semester.

When reforming the European Semester, the European Commission faces trade-offs between the tightness of enforcement mechanisms and ownership as well as between rule-based and case-by-case decisions. Implementation of recommendations could be improved in the short run (leaving aside any considerations of political feasibility) by tightening some of the enforcement mechanisms, i.e. by implementing rule-based automatic sanctions and, if necessary, by tightening these sanctions. However, such a modification of the European Semester could have several drawbacks:

- The tightening of enforcement mechanisms could lower the level of ownership for the recommendations. To the extent that a tightening of enforcement rules leads to lower ownership, the European Semester could become less efficient even if the implementation rate increases.
- A rule-based mechanism typically relies on specific indicators and thresholds. Such indicators and thresholds are in their very nature imperfect and their optimal values may vary over time. In some critical areas, i.e. those in which the functioning of the EMU as a whole is in danger, it may be preferable to implement such an imperfect rule-based mechanism compared to a situation in which recommendations are not implemented at all. However, it is difficult to assess what costs and what benefits would be associated with such a mechanism.
- For political reasons, indicators and thresholds are usually chosen and applied equally across all countries and economic environments. Given that optimal indicators and thresholds would vary across countries and be dependent on the country-specific economic environment, case-by-case decisions are preferable. However, such a process can lead to situations in which sanctions are systematically avoided politically, as has frequently been the case within the Stability and Growth Pact.

The European Semester should prioritise areas of common interests of the EMU. Given that implementation of recommendations in the short and medium term can only be significantly improved by tightening enforcement mechanisms, and given that such a tightening could entail substantial costs, the Commission should differentiate explicitly between (1) developments that lead to significant risks to common interests of EMU and (2) developments that may only adversely affect a single Member State. For policy recommendations that seek to avoid instabilities of the first kind, a tightening of enforcement mechanisms seems to be more appropriate than for those of the second kind. Given the current institutional framework, issues that fall in the first category particularly include issues of financial and debt sustainability to avoid banking and debt crises. Issues like growth prospects and labour market

reforms rather belong to the second category as they do not address systemic risks that adversely affect common interests.

The enforcement mechanisms that deal with the areas of financial and debt sustainability should be tightened. With regard to debt sustainability within the Stability and Growth Pact, a tightening of the enforcement mechanisms should start by applying the existing rules more strictly instead of weakening the rule-based system introduced with the Maastricht Treaty, and revised by the two-pack and six-pack regulations, by a case-by-case decision procedure. This has led to a situation where no sanctions were imposed despite continuous breach of the Maastricht criteria. The ownership for recommendations that aim to ensure debt sustainability could be improved by strengthening independent debt commissions on the national level consisting of independent experts that assess the appropriate fiscal stance based on transparent fiscal rules that are designed in accordance with the European fiscal regulation (Snower et al. 2013). Sanctions do not have to exclusively focus on financial sanctions but could also include elements, such as restricting voting rights or restricting the number of positions in relevant institutions. While the Eurogroup with its informal character may not be the prime candidate for such institutional sanctions, it could be used to increase peer pressure, as has been tested in the context of the political struggle around further financial assistance to Greece at the meeting on June 27, 2015. As the trustful cooperation among the members of the Eurogroup is highly important the limitation of voting rights is a sensible issue. Nevertheless, the Eurogroup could adopt the rule its President cannot come from a Member State that violates the fiscal criteria of the Stability and Growth Pact.

With regard to financial stability, the European Semester faces a significant overlap with other EU institutions that directly address this area. Once these institutions are fully operational, the case for the European Semester to deal with this area will vanish. For the time being, however, the analysis of macroeconomic developments within the European Semester may be seen as a useful supplement, with the MIP becoming the relevant surveillance mechanism. However, in its current form the underlying concept of macroeconomic imbalances is too vague and its enforcement mechanisms seem to be too weak to deal effectively with macroeconomic imbalances that have the potential to trigger banking crises.

The MIP should be strengthened by focusing on financial stability and by unbundling it from other policy targets that are addressed elsewhere in the European Semester. The MIP is a procedure for preventing macroeconomic imbalances that are "adversely affecting, or have the potential to adversely affect the proper functioning of the economy of a Member State of the economic and monetary union or of the Union as a whole" (European Parliament 2011). Currently, the MIP suffers from several drawbacks. The concept of macroeconomic imbalances is theoretically not well-founded and vague. Moreover, there is a large overlap with other parts of the European Semester, in particular with respect to enhancing potential growth in EMU. This overlap weakens the efficiency of the European Semester to an extent that it becomes ill-focused and less transparent. Furthermore, the MIP does not sufficiently differentiate between macroeconomic imbalances that may adversely affect common interests (i.e., the functioning of the EMU as a whole) and those whose impacts remain within a single Member State. However, as discussed above, this is a very important feature of macroeconomic imbalances with regard to the appropriate enforcement mechanisms. Therefore, we recommend streamlining the MIP to focus exclusively on macroeconomic imbalances that may trigger financial instabilities and banking crises.

The streamlining of the MIP should start with streamlining the Scoreboard. The evaluation of the Scoreboard, an indicator-based signalling device for harmful imbalances, is the starting point of the MIP. Streamlining the MIP implies also to streamline the Scoreboard to focus on indicators that have been proved to deliver reliable early warning signals for banking crises, such as credit volumes and house prices, and remove indicators that do not provide any early warning signal and that are relevant for policy areas that are covered in other parts of the European Semester, such as the unemployment rates or unit labour costs (Boysen-Hogrefe et al. 2015, forthcoming). Likewise, we advise developing early warning indicators that are economically more meaningful, for example indicators that cover potentially badly allocated business investments (bubbles) and the role of distorted capital stock structures for financial

crises, and using them to replace indicators that mainly reflect symptoms of upcoming crises, such as current account deficits or indicators of price competitiveness.[12]

The European Semester should make full use of soft enforcement mechanisms. The Commission has aimed at continuously strengthening soft enforcement mechanisms, such as peer reviewing and best-practice exchange, the dialogue with national authorities, and transparency and communication to the public. Even though the strengthening of all of these soft enforcement mechanisms will probably not significantly improve the efficiency of the European Semester in the short to medium term and is not sufficient to ensure stability in those areas that may adversely affect common interests, such as financial imbalances and debt crises, they are of utmost importance to further strengthen the efficiency of the European Semester in the medium to long term, in particular by strengthening the level of ownership. Given the disadvantages of strict enforcement, these soft enforcement mechanisms are most appropriate to make the European Semester more efficient with regard to those areas that are not concerned with common interests, such as the goals of Europe 2020, and, therefore, should be further strengthened.

The transparency of the European Semester should be strengthened by developing a coherent theoretical framework for areas of common interest. The European Semester is based on an eclectic theoretical approach rather than a coherent theoretical framework. Such a theoretical framework would improve the transparency of the European Semester, strengthen ownership, and thereby the success of the suggested policy recommendations. In the case of the MIP, the lack of such framework resulted in a Scoreboard that more closely resembles a conglomerate of loosely connected variables rather than a battery of coherent indicators. While it is true that the Scoreboard is used as a signalling device only (and not as a set of targeted indicators), the problem of insufficient theoretical foundations becomes relevant in the economic reading of the Scoreboard and the derivation of policy recommendations. To be sure, reaching consensus on a consistent theoretical framework will be an extremely challenging task as there is a great variety of different candidates for such a theoretical framework, and each of them is subject to advances in economic theory and empirical insights. However, such a framework is imperative for areas of common interest because as long as no common understanding of issues that threaten common interests exists, it will be extremely difficult to create ownership for recommendations that deal with such issues.

5.2 The proposals of the European Commission to improve the efficiency of the European Semester from October 2015 – A first assessment

On 21 October 2015, the European Commission published proposals to take forward key elements of Stage 1 of the Five Presidents Report that aims to deepen EMU using the existing instruments. One part of the proposals deals with improving the European Semester, including a better integration of the euro area as a whole in the Semester, a stronger focus on employment and social performance, a stronger focus on benchmarking and pursuing best practices, and more support for reforms through EU funds and technical assistance. Other parts include improving the transparency of the SGP and the MIP, creating a system of National Competitiveness Boards and an advisory European Fiscal Board, and steps towards a financial union. Finally, the European Commission proposes to further strengthen the dialogue with national authorities and with the European Parliament.

The most important proposals include further strengthening benchmarking and pursuing best-practices, improving the transparency and reducing the complexity of the current fiscal rules and the MIP. The proposals are described in relatively general terms making a detailed assessment difficult. Clearly, improving transparency and reducing complexity tends to increase ownership and the efficiency of the whole European Semester. Moreover, the proposals to accomplish the banking union aim at reducing the negative bank-sovereign loop and are key elements of further improving the general institutional framework, which would relieve the European Semester somewhat of the task of preventing

[12] See Boysen-Hogrefe et al. (2015) for a comprehensive analysis.

systemic events in the EMU. To the extent that the implementation of reforms in some countries is hampered by a lack of personal resources or expertise technical support from the Commission may be helpful. A further strengthening of communication of European executive institutions with national authorities and the European Parliament to increase ownership and democratic legitimacy is very important to improve the efficiency of the European Semester. An instrument that can be capitalized upon in this respect is the Economic Dialogue that the European Parliament holds on a regular basis as well as ad hoc to discuss economic issues and exchange views in public hearings with several European bodies, including the President of the Eurogroup.

Several proposals are not of particular importance for improving the efficiency of the European Semester, may complicate the European Semester, or may even weaken its efficiency. The proposals to take the euro area dimension more into account and to implement a system of national Competitive Boards are questionable (see Section 4.2). If the Commission wants to put a stronger focus on employment and social performance it should do so by using soft enforcement mechanisms (communication) that are appropriate for policy coordination of category one (information sharing). Dealing with these issues within the MIP could be counterproductive. To the extent that the MIP aims also at dealing with issues that could have an immediate negative impact on common interests (and to the extent that employment and social performance do not impose a systemic threat to EMU) this would overload the procedure, blur its focus, and make it more difficult to find appropriate enforcement mechanisms. This would also counteract efforts of the Commission to increase the transparency of the MIP, such as clarifying guiding criteria for its decisions and the links between identified imbalances and policy recommendations that the Commissions also proposes.

Establishing an independent Advisory European Fiscal Board can help improve transparency and acceptance of the European fiscal framework. The Advisory European Fiscal Board is designed to give an independent assessment of the implementation of the fiscal rules (European Parliament 2015c). The proposed focus on evaluation of horizontal consistency in the decisions taken and cases of serious non-compliance suggests that part of its role will be to strengthen the position of the Commission in the political process, provided that the Commission view is solidly grounded on the Board assessment and the independence and scientific excellence of the Board members is out of question.[13] The Board's tasks include cooperating with national fiscal councils and facilitate exchange of best practices, which has certainly the potential to improve the functioning of the European Semester and increase ownership of policies designed within the European fiscal framework. The role of the Board as advisor on the appropriate fiscal stance for the euro area is nevertheless to some extent problematic as there is no fiscal capacity of the euro area so far. Evaluating the consistency between national fiscal policies and the advised fiscal stance of the euro area as a whole is not necessarily helpful as national governments would be ill-advised to act against their country's macroeconomic interests (see above).

Strengthening the role of the President of the Eurogroup can contribute to a more coherent economic policy in the euro area. The President of the Eurogroup has an important role in the process of economic policy coordination in the euro area. He chairs the Eurogroup meetings and sets the agenda for them and thus has a strong influence on the outcomes of the meetings. In addition, he maps out the work programme of the Eurogroup on a semi-annual basis, implying again a decisive impact on the design of policies and the evolution of the institutional set-up of EMU. In his capacity as a representative of the euro area in the Economic Dialogue with the European Parliament he is instrumental in making the policies at euro area level more transparent and in raising the understanding in the public. Establishing the President of the Eurogroup as a unified external representative of the euro area in the international arena would further strengthen his position in the European institutional framework. Having a single representation of the euro area is appropriate especially when it comes to monetary issues and financial regulation given the single currency and the progress that has been made in accomplishing a Banking

[13] One weakness in this respect can be seen in the fact that there is no outside control of the appointment of the Board members, such as e.g. approval by the European Parliament.

Union, and therefore the lack of a unified voice in the IMF is particularly inadequate. However, as long as the President of the Eurogroup comes from the group of acting ministers of finance he may face conflicts of interests whenever issues of his own country may be out of line with euro area requirements.

Overall, the proposals of the European Commission include some relevant aspects but do little to further streamline the European Semester and set priorities. The communication of the Commission seems to exhibit a bias towards more policy coordination observed in many proposals since the recent crisis-events. However, it is not obvious that more policy coordination is always better. In our view, a consolidation of the current European Semester would be a more promising strategy instead of overloading the European Semester with more task and tools. Such a consolidation strategy could consist of further streamlining the European Semester, setting priorities, using enforcement mechanisms that are consistent with the priorities, and consistently using one instrument only for one target.

6. CONCLUSIONS

The European Semester operates in a complex institutional environment that creates several trade-offs for the implementation of intra-EMU policy coordination:

- **Subsidiarity vs. policy coordination in general**
  The principle of subsidiarity, a key pillar of the European architecture introduced to make full use of the advantages of diversity within the EU, suggests to shift competences to the lowest possible government level. By its very nature, policy coordination works in the opposite direction. No conflicts arise, however, if intra-EMU policy coordination addresses the well-functioning of the euro area as a whole (common interest).

- **Soft vs. strict enforcement**
  While soft forms of coordination (such as peer reviewing, dialogue with national authorities, and communication to the public) come at the cost of relatively weak implementation rates stricter enforcement mechanisms (rule-based approaches triggering automatic sanctions) are also problematic as optimal rules, indicators, and thresholds vary across countries such that the resulting recommendations would be notoriously sub-optimal.

- **Short-run vs. long-run requirements**
  The need for operational policy coordination within the European Semester depends on the general institutional framework of the EMU, in particular with respect to the stability of the financial sector and the fiscal soundness of the Member States. As long as the risk of negative cross-country spill-overs emerging from these sources persists the European Semester may have to address policy areas (short- and medium-run) that will lose relevance once these destabilizing factors will be successfully contained (long-run).

For the time being, the European Semester operates in an environment, in which systemic events in one Member State can still threaten the functioning of the EMU as a whole. It therefore seems appropriate to use the mechanisms of the European Semester for intra-EMU policy coordination, including procedures culminating in sanctions in the case of persistent non-compliance, to address this common interest.

The permanent role of the European Semester, however, rather rests on soft policy coordination mechanisms (in particular peer-reviewing and best-practice exchange) to promote policies that improve economic development within each Member State (e.g., growth, employment, convergence).

Against this backdrop, our suggestions to improve the efficiency of the European Semester include:

- Explicitly differentiating between policy areas that are relevant for the functioning of the EMU as a whole and those that are relevant for the economic development of a single Member State, and clearly prioritising the former in the European Semester.

- Assigning only one target to one instrument. While the Stability and Growth Pact should focus exclusively on public debt sustainability and the MIP should address financial stability from a macroeconomic perspective (early-warning for crisis prevention) other instruments may focus on strengthening growth prospects or labour market institutions of Member States.

- Using strict enforcement mechanisms (rule-based automatic sanctions) in those areas that are relevant for well-functioning of the EMU as a whole and soft enforcement mechanisms in other policy areas.

- Making full use of soft enforcement mechanisms by increasing peer-pressure and facilitating implementation of appropriate policies through more transparency and current information on the process of implementation. Tighten, if necessary, the strict enforcement mechanisms.

- Elaborating a coherent theoretical framework for those events that threaten the functioning of the EMU as a whole. A common understanding is crucial for creating ownership for policy initiatives that are supposed to address common interests shared by all Member States.

- Policy recommendations for the euro area as a whole are problematic and may weaken economic policy coordination within the euro area.

- Communicating that the European Semester is no panacea. Like any other macroeconomic surveillance and coordination mechanism its capacity to prevent systemic economic crises will be limited.

- Prioritising the prevention of excessive risk-taking rather than creating risk-sharing mechanisms (safety nets, EMU-wide macroeconomic shock absorbers). The EMU should strive for becoming the world's financially most robust, market-oriented economic area.

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