IN-DEPTH ANALYSIS

European Parliament

Euro Area Scrutiny

External expertise on economic governance issues during the 8th Parliamentary term

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Euro Area Scrutiny

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Abstract

This document provides the summaries of all external experts papers published during the 8th parliamentary term (2014-2019) by the Economic Governance Support Unit, aimed at supporting the scrutiny work on the functioning of the Euro Area, especially in view of the bi-annual Economic Dialogues with the President of the Eurogroup.

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ABOUT THE EDITOR

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INTRODUCTION

This document provides the summaries of all external experts papers published during the 8th parliamentary term (2014-2019), aimed at supporting the scrutiny work on the functioning of the Euro Area, especially in view of Economic Dialogues with the President of the Eurogroup. During this parliamentary term, the President of the Eurogroup has appeared, as a matter of practice, twice a year for a dialogue in the competent Committee of the European Parliament.

The papers have been provided twice a year, aligned with the spring and autumn work programmes of the Eurogroup. They have been written by prominent external experts, upon request of the competent Committee of the European Parliament and under the supervision of its Economic Governance Support Unit (EGOV). The topics addressed by these papers relate to the economic governance framework of the Economic and Monetary Union.

In addition, papers supporting the scrutiny of the Banking Union, in particular in advance of public hearings with the Chair of the Single Supervisory Mechanism and the Chair of the Single Resolution Mechanism, have been provided upon request of the competent Committee during the whole parliamentary term.

External expertise is also made available in advance of Monetary Dialogues. As part of this scrutiny work on the euro area by the competent Committee(s) of the European Parliament, the EGOV Unit has also prepared and published, on regular basis, briefings related to the implementation of the economic governance and banking union frameworks. These briefings are also available on the homepage of the ECON Committee.

On 1 January 1999, 11 countries of the European Union (EU) adopted fixed exchange rates, adopted a shared monetary policy under the European Central Bank and launched a new common currency: the euro. It was initially a currency used in financial markets and for cashless payments. Three years later, euro banknotes and coins entered into circulation. Today, the euro is the currency of 19 EU countries and over 340 million Europeans, and has become one of the most important currencies in the world.

On 1 January 2019, the Euro celebrated its 20th anniversary.

Table 1: External experts' papers related to euro area governance during the 8th parliamentary term

Publication date	Topic	Authors and link
Autumn 2018	Debt Sustainability Assessments: The state of the art	G.Corsetti
		D.Gros, C.Alcidi
Spring 2018	Convergence in EMU	J.Creel
		M. Dolls, C. Fuest et al
Spring 2018	Simplification of the Stability and Growth Pact	G.Kopits
		C.Cottarelli
		F.Heinemann
Autumn 2017	Strengthening of the European Semester	X.Ragot
		C. Alcidi, D. Gros
Autumn 2017	Possible New Regime for Banks' Sovereign Exposure	N.Veron,
		Y.M.Schneider, S.Steffen
Spring 2017	The role of macro-prudential policies in the Euro Area	J.Couppey-Soubeyran, S.Dehmej
		M.Rubio
May 2017	An evolutionary path towards a European Monetary Fund	J.A.Rodden
		Ch.Wyplosz
		D.Gros
Summer 2016	The Euro area fiscal stance	F.Giavazzi
		A.Benassy-Quere
		E.Ademmer, C.Boeing-Reicher et al.
Summer 2016	Structural reforms and the role of the Eurogroup	A.Benassy-Quere
Autumn 2015	Economic policy coordination in the euro area under the European Semester	K-J.Gern, N.Jannsen, S.Kooths
		A.Bénassy-Quéré
		F.Zuleeg
		D.Gros, C.Alcidi
		Z.Darvas, A.Leandro
Autumn 2015	Economic Governance Structures in the USA	J.F.Kirkegaard
Spring 2015	Debt sustainability and economic convergence of euro area Member States: challenges and solutions	Paolo Mauro
		Xavier Ragot
		Clemens Fuest
		Paolo Manasse
Autumn 2014	Fiscal and macro-structural challenges and policy recommendations for the Euro Area and its Member States under the 2014 Semester Cycle	Dr. J. F. Kirkegaard
		Dr P. Bofinger
		D.Gros, C.Alcidi

Debt Sustainability Assessments: the State of the Art

November 2018

In their paper, **C. Alcidi and D. Gros** (*CEPS, Brussels*) differentiate DSA as a standard instrument of fiscal surveillance in normal times ("economic surveillance DSAs") and as a tool for taking decisions about the provision of financial support ("hard DSAs"). Given the fundamental relationships between debt, deficits, interest rates and growth, the result of a DSA depends ultimately on the assumptions about the parameters. One caveat of this approach is that it applies empirical regularities from the world-wide economies and in the pre-euro period to estimate such parameters; the authors note that this may be misleading for euro area countries. The paper presents the main differences between the IMF and the COM approaches, and notes that such differences are more relevant when DSA is used in the context of financial assistance, than in regular surveillance. An important difference is due to the time horizons: the IMF uses the five-year horizon of its Word Economic Outlook projections for both "surveillance" and "hard" DSA, while the COM has usually a ten-year horizon. This is related to the size and scope of the respective potential financial assistance: the IMF provides limited amounts of financing, of a short- to medium-term nature and with a substantial top up over risk free rates; therefore, the DSAs of the IMF focusses on the ability of a country to finance itself in the market and repay the IMF after 5 years. Financing by the ESM in the Euro Area, by contrast, can be large, cheap and of such a long maturity that the program itself can have a major impact on the long-term debt sustainability. On fiscal sustainability indicators used in the context of "economic surveillance DSAs", the authors argue that they are somewhat less judgmental: on the one hand, certain indicators have proven to be useful warning signals of future fiscal stress, on the other hand, they point to different directions and it is difficult to extrapolate a univocal conclusion.

In his paper, **G. Corsetti** *(University of Cambridge)* notes that the approach to DSA has substantially evolved after the global economic and financial crisis. The main goal now is to improve the detection of risks. To this scope, DSAs make use of an increasing number of indicators and systematically include both implicit and contingent liabilities; DSAs also use statistical methods to quantify highly risky "tail events". Furthermore, DSAs more and more often set "debt limits", by adopting thresholds for debt and payment flows, which are used to single out enhanced vulnerability. While these developments mark true progress, this paper argues that some issues should be incorporated to improve the predictive capacity of DSA, focusing mainly on liquidity (versus solvency) risks and contagion risks. The identification of fixed "debt thresholds" is another critical area, limiting DSA effectiveness: the author argues that such limits should not be fix, neither across countries nor over time. In the paper, the author explains why DSA should embed potentially available official support: according to this approach, therefore, the limited clarity of the design of the financial support - as currently in the EMU - constitutes a hurdle for a comprehensive DSA. The author also shows that different risks require different financial assistance tools, and that the (negative) role of self-fulfilling expectations can be prevented by designing appropriate instruments, while taking into account moral hazard aspects. The paper concludes with a comparative assessment of current standard DSAs models and applications, suggests directions for further improvement, and discusses the correct use of DSAs in light of the strengths and weaknesses inherent the underlying methodologies.

The Simplification of the Stability and Growth Pact

April 2018

C. Cottarelli (*Observatory on Public Accounts Università Cattolica*) argues in his paper that the complexity of the SGP, which may have contributed to its limited effectiveness, reflects largely the conflict between the need to make the original SGP rules more stringent and the desire to allow flexibility with respect to various country circumstances. Once that the effects of the largest economic shock since the 1930s have faded away, a major simplification of the system could be achieved by removing some margins of flexibility, without changes in the legislation. Another approach would be legal simplification, including relaxing some of the SGP long-term parameters or reconsidering the coexistence of the MTO rule and the expenditure benchmark. A more radical solution would be shifting to a single rule in which an "operational target" responds to deviations of public debt from its long-term objective.

F. Heinemann (*Centre for European Economic Research (ZEW) Mannheim and University of Heidelberg*) acknowledges in his paper that past reforms of the Stability and Growth Pact (SGP) have improved its economic rationale, but this progress has come at the expense of simplicity, transparency and, possibly, enforceability. This study surveys and evaluates reform models that could reduce complexity without compromising the SGP's indispensable flexibility. From a holistic perspective, the greatest potential for simplification will result from a shift of discretionary power to an independent fiscal institution. Independence is a substitute for complexity. With a narrower focus on the potential streamlining of the SGP and a reduction of excess complexity, first, the preventive and corrective arms could be integrated into one procedure. Second, this integrated procedure should be centred on a net expenditure rule that is combined with a debt feedback mechanism and a memory for expenditure overruns. Third, further fiscal indicators that are currently treated as parallel targets (headline deficit rule and structural balance) could be downgraded to non-binding reference values. And fourth, the planned transposition of the Fiscal Compact into European law should follow SGP reforms, in order to promote consistency between European and national fiscal rules.

G. Kopits (*Woodrow Wilson Center and Portuguese Public Finance Council*) states in his paper that an assessment of the present SGP fiscal rules reveals a significant deterioration in simplicity, undermining their effectiveness. In fact, in both design and process, they have become the most complex worldwide. Three options for future reform are offered to correct this deficiency. Under the first, the structural balance and the debt convergence targets are replaced with a debt-stabilizing or -reducing primary surplus target, while retaining the expenditure benchmark. The second consolidates all current rules into a single operational debt rule by setting a limit on the discretionary budget deficit, derived from the debt reduction target. The third option consists of a market-based approach which is essentially an autonomous regime of rules, in contrast to coordinated or centralized regimes.

Convergence in the EMU: What and How?

May and June 2018

M. Dolls and C. Fuest *et al* (*CESifo)* note in their paper that convergence is one of the key goals of the European Union and has been at the centre of many recent debates. This paper strives to identify the types of convergence that are pivotal to the well-functioning of the euro area and discusses their role in the context of the EMU's governance framework. Evidence suggests that key economic indicators have converged for some Member States before coming to a halt (or even diverge) with the onset of the global financial and euro area debt crises. As economic convergence depends mostly on the policies of the Member States, the authors call for a strengthening of national responsibility for structural reforms. The authors discuss strengths and shortcomings of the recently proposed reform delivery tool and present our proposal of 'national convergence roadmaps'. They propose that member states can apply for resources from the European Structural and Investment Funds by committing to convergence targets and submitting reform plans in the context of the European Semester. If positively assessed by the European Commission and approved by the Council, the reform efforts could be financially rewarded – conditional on the potential for positive spill-overs, continuous implementation of the reforms and achievement of the convergence targets.

In his paper, **J. Creel** (*ESCP Europe & OFCE, Sciences Po*) notes that one major characteristics of an optimal currency area is its ability to maintain or foster integration and convergence among its Member States. This objective requires reaching a stable economic and financial situation and developing resilience to shocks. After reviewing the state of convergence in the euro area, this paper proposes a number of recommendations, aimed at improving convergence towards the so-called "steady state", as well as financial and cyclical convergence. Recommendations focus on several policy areas, including cohesion policy, the statute of the ECB, public and private debt sustainability, fiscal rules and minimum wage policy.

Strengthening of the European Semester

November 2017

C. Alcidi and D. Gros (*Centre for European Policy Studies*) state in their paper that the emphasis of the European Semester should shift from economic policy coordination – intended as the process through which Member States commit to common rules and recommendations adopted by the Council of the European Union under the surveillance of the European Commission – to a stronger national ownership. Coordination of national policies may be essential at times of crisis, when cross-country spillover effects tend to be large, but it may not be very effective when economic conditions return to normal, as spillovers tend to be small and the incentives for governments to coordinate lessen. Stronger national ownership should lead to better enforcement of commonly agreed rules, regardless of economic conditions and should take away the perception that rules are hierarchically imposed. National ownership could be improved by involving the national fiscal councils and the national productivity boards explicitly in the elaboration of EU recommendations for national governments. This should be done without increasing the complexity of an already complicated EU governance system of governance or damaging their reputation as independent bodies. Reforms aiming to improve the structural functioning of the EU's economies are of critical importance for Member States, yet the reasons why specific reforms should be embedded in the Semester are not always clear. Moreover, strengthening the Semester by further linking the EU budget to reforms undertaken in the Member States is fine in theory but very difficult in practice. Reforms cannot be 'bought' as such and it would be extremely difficult to measure the implementation of the CSRs precisely enough to make implementation a condition for funds. The role of the Commission should remain predominant in fostering coordination in case of economic crisis and in providing technical support for reforms whenever needed.

X. Ragot (*OFCE and SciencesPo-CNRS*) acknowledges in his paper that the improvement of the European Semester is an on-going process. However, this process of annual coordination should focus more on macro-economic policies with potentially strong spill-overs, which can only be addressed at the European level. Among these, one can identify diverging nominal trends and deflationary pressures at the euro area level, an inadequate fiscal stance, and unsustainable current account imbalances. To address these issues, he puts forward seven specific suggestions on how to further improve the current economic coordination and surveillance process:

1. Request National Productivity Boards to focus more on nominal trends across tradable and non-tradable sectors and on the labour markets;
2. Based on the inputs of National Productivity Boards and the Commission, define a nominal wage stance in the euro area consistent with the ECB target. Use this nominal stance to issue relevant CSRs;
3. Provide a hierarchy of CSRs based on a degree of spill-overs the requested reforms have onto other Member States;
4. Systematically add CSRs about environmental issues and possibly energy policy, as these recommendations tackle issues with clear externalities;
5. Add a temporal dimension to recommendations, with a possible medium-run time horizon, distinguishing between intermediate steps and final goals;
6. Start the European Semester with an assessment of the European economic situation on key aspects: Fiscal aspects (fiscal sustainability and fiscal stance), social aspects, financial aspects (based on current account imbalances) and nominal aspects (nominal and wage stance);
7. To improve democratic debate, a systematic communication on CSRs with externalities would considerably ease national ownership. The Commission has to be heard by national parliaments to discuss potential European externalities, while the European Parliament should scrutinize the assessment by the Commission of these policies with strong externalities.

Feasibility Check: Transition to a New Regime for Bank Sovereign Exposure

November 2017

N. Véron (*Bruegel & Peterson Institute for International Economics)* makes in his paper a concrete proposal for a Sovereign Concentration Charges Regulation (SCCR), including calibration and careful transitional arrangements to avoid any disorderly market impact. The SCCR and EDIS together could realistically receive political approval in 2018 and be fully implemented within a decade. Achieving the aim of Europe's banking union project, to break the vicious circle between banks and sovereigns, requires new policy initiatives. The most direct bank-sovereign linkages are national deposit insurance and concentrated domestic sovereign exposures. Thus, simultaneously with a European Deposit Insurance Scheme (EDIS) as proposed by the European Commission in 2015, the European Union should introduce regulatory disincentives against highly concentrated sovereign exposures of euro area banks.

Y. M. Schneider (*University of Mannheim*), and **S. Steffen (***Frankfurt School of Finance & Management*) argues in their paper that excessive sovereign debt exposures of banks contributed to the gravity of the financial and sovereign debt crisis in 2011 and 2012, as well as to the slow and asymmetric recovery of European countries. Various policies that improve banks' resilience were introduced in recent years, however the regulatory regime for the sovereign debt exposure of banks has not changed. The authors identify four criteria that a new regime for bank sovereign exposures should fulfil: (1) attenuate the home bias to the domestic sovereign, (2) break the doom loop, (3) avoid a flight-to-quality of assets, and (4) mitigate risk spillovers. The authors assess the implications for banks' balance sheets for five policy proposals, based on simulations on a sample of European banks. They show that none of the proposals would fulfil all four criteria in the absence of a safe asset. They conclude that a new regime for bank sovereign exposure should be conditional on restoring the value of sovereign bonds as a safe asset.

An evolutionary path to the European Monetary Fund

May 2017

C. Wyplosz (*the Graduate Institute, Geneva*) notes in his paper that the creation of a European Monetary Fund seems a natural next step to improve upon the European Stability Mechanism. Prof. Wyplosz argues that such a step is neither necessary nor desirable, for many reasons. First, the European Stability Mechanism is a fundamental contradiction with the no-bailout rule, which is arguably the most crucial instrument to foster fiscal discipline in the Eurozone. Second, any insurance mechanism creates moral hazard. A European Monetary Fund would be deeply immersed in conflicts of interest among its members. Third, it would have to fit in alongside the Commission and the Eurosystem, already in charge of monitoring the Eurozone countries, preventing crises, lending in last resort and developing debt-restructuring principles. Fourth, it would need a highly competent staff to deal with crises but idle in quiet times. Fifth, its governance should guarantee fast action when needed, with proper accountability and undue politicisation. These are serious hurdles and the IMF can perform the task.

According to a paper by **D. Gros** (*CEPS, Brussels*), there is no need for Europe to replicate the International Monetary Fund (IMF). The European Stability Mechanism (ESM) can provide the backstop for sovereigns, even without a financial contribution from the IMF. In this sense, the ESM already constitutes to a large extent a 'European Monetary Fund'. Other IMF functions such as surveillance and policy coordination should remain with the European Commission, the Eurogroup and other existing bodies. The ESM will be called upon to act as a backstop only intermittently, in times of great financial market instability. The need for it will evolve as a function of the nature of financial markets and their cross-border integration. It is not possible to forecast with any precision when the next financial crisis might break out and what form it will take. Any evolution in the functioning of the ESM should thus aim at enhancing flexibility and clarity of its overall mandate (financial stability), rather than revising the details of the rescue mechanism (which should be extended to the Single Resolution Fund) and its modus operandi. Moreover, the ESM should be viewed as the natural instrument for unifying the euro area's representation in the IMF.

In his paper, **J.A. Rodden** (*Stanford University*) presents the EMF from a comparative perspective with the USA. Eurozone reformers are looking to the United States and other federations as they seek to craft a more sustainable architecture for the Euro. This paper first extracts lessons about mechanisms of intra-regional insurance and redistribution, and then turns attention to related debates about moral hazard and fiscal discipline. In the United States, intra-regional fiscal stabilization is achieved through a progressive income tax. Contrary to common wisdom, federal direct expenditures and grants are targeted neither to states suffering from short-term asymmetric negative shocks nor to relatively poor states in the long term. Fiscal policies of state and local governments are highly pro-cyclical, and partially undermine the stabilizing role of the system of federal taxes and transfers. Thus the U.S. experience suggests a number of design challenges facing any future Eurozone stabilization mechanism. The paper also places proposals for even stronger top-down surveillance and correction mechanisms of Eurozone member states' fiscal policies in comparative perspective, arguing that such powers are not found in unions of sovereigns like the United States, Canada, and Switzerland. Moreover, there are reasons for concern about the credibility of such efforts in the Eurozone as currently structured. Unless political will can be found for extraordinary political and fiscal centralization, reformers should assume that member states will continue as sovereigns, and hence will be disciplined (or not) by voters and credit markets rather than European regulators. Thus it might be useful to consider policies that would make the "no-bail out clause" credible.

The role of macro-prudential policies in the Euro Area

May 2017

M. Rubio (*University of Nottingham*) reviews in her paper the key issues that are relevant for the implementation of macroprudential policies in the euro area and questions the current institutional framework. Finally, it gives some policy recommendations on how to improve the current situation. In the aftermath of the financial crisis, there is consensus among academics and policy makers on the need for the so-called macroprudential policies. Additionally, the current low interest rate environment creates further risks to financial stability. However, the implementation of such policies in a monetary union is a rather complex issue. Housing and credit markets heterogeneity across countries calls for action at national level. The role of the ECB in macroprudential policy is a matter of debate because monetary policy can conflict with the ultimate goal of macroprudential policy.

Drawing on an inventory of the current practices and the teachings of recent academic work, **J. Couppey-Soubeyran** (*Université Paris 1, Centre d'économie de la Sorbonne & CEPII*) and **S. Dehmej** (*Bank Al-Maghribwe*) formulates in their paper 15 proposals which aim to identify effective macro-prudential instruments to achieve this stability and, in a context of institutional transformation (Banking Union, Brexit, etc.) likely to facilitate changes, to streamline the institutional framework. The euro area suffers from economic and financial imbalances between its members. Macroprudential policy can help remedy this in as much as it can be deployed both at euro area level and Member State level. A macro-prudential policy framework to regulate financial cycles at Member State level and improve the resilience of systemic groups at euro area level would improve the economic and financial stability of the euro area and each of its members.

Structural reforms and the role of the Eurogroup

November 2016

H. Enderlein and **J. Haas** (*Jacques Delors Institut – Berlin*) analyses in their paper the role of the Eurogroup in European economic governance. Since the euro crisis, there can be no doubt about the importance of coordinating economic policies in area currency union. But the main coordination framework, the European Semester, is not yet working as intended. Some hopes rest on a stronger role of the Eurogroup. In 2014, it started holding "thematic discussions on growth and jobs", i.e., on structural reforms. They argue that there is no single criterion for evaluating the effectiveness of the Eurogroup. Instead, success depends on how one sees its ideal role in economic policy coordination. The Eurogroup can act as: (1) a consensus-builder through policy learning and persuasion, (2) an EMU architect on the basis of hard coordination, and (3) a supervisor of the member states via peer pressure. The authors find that thematic discussions are moderately effective in building consensus, but mostly ineffective in helping implement CSRs for the entire euro area and ineffective in monitoring reform implementation in the member states. The important, and increasingly formal, tasks the Eurogroup has been assigned in the European Semester are not mirrored in the group's working methods and legal foundations.

The Euro area fiscal stance

July 2016

A. Bénassy-Quéré *(Paris School of Economics, University Paris 1 Panthéon-Sorbonne)* notes in her paper that the concept of fiscal stance aims at assessing the "voluntary" impulse induced b fiscal policy, as opposed to "automatic stabilisers". In the current economic governance framework, where only coordination among euro area Member States is possible, the design and implementation of a Euro area fiscal stance is especially difficult, in the absence of a Euro area budget. Therefore, the only possibility is to coordinate national fiscal policies, in order to mimic what a federal budget could achieve. She argues that such "top-down" approach should apply only in "exceptional" times, when fiscal spillovers are high and the Euro area is at risk. In "normal" times, the usual "bottom-up" approach remains appropriate. The author highlights the weakness of the concept of "fiscal stance", due to changes in the forecasts of both the actual and potential GDP growth: to overcome this problem, she proposes to rely on the current account estimates, which seem more reliable and less volatile. In order to "distribute" the fiscal stance among euro area countries, both the output gap and current account of each country need to be taken into account, on the top of each country's "fiscal space" that results from the debt ratio. She also proposes a calendar that could better fit the European semester and the preparation of Member States' budgetary plans. As far as democratic legitimacy is concerned, the legitimacy of a "top-down" approach for fiscal policy would mainly rely on "output legitimacy" (i.e., it would be based on its efficacy). However, the recently established European Fiscal Board could have an impact, by raising the level of awareness within the European and national Parliaments; the President of the EFB would appear in front of the EP and selected Member States. Since national governments and parliaments will remain responsible for national fiscal policies, fiscal coordination will remain fragile, especially when the macroeconomic situation differs largely across Member States. Therefore, the coordination of national fiscal policies should be complemented by the development of a "fiscal capacity" for the euro area.

K-J. Gern et al. *(Kiel Institute for the World Economy)* argue in their paper that the joint euro area fiscal stance is not a useful concept, because i) only national authorities can conduct fiscal policies and ii) the concept abstracts too much from the relevant information at country level (especially debt sustainability concerns). Furthermore, from the methodological standpoint, the structural balance is a weak indicator, because it depends on the output gap and on the potential output of an economy, which have proven very volatile. The authors note that in the current context, the EU Commission requires Member States with fiscal space (i.e. sound debt position, e.g. Germany) to provide fiscal stimulus, in the hope that loosening the joint fiscal stance would help countries that cannot afford a more expansionary fiscal stance. The authors argue that this would damage the national economy and its sustainability, and would induce further business cycle divergence among euro area Member States. Furthermore, the impact on the other MSs might be opposite to the expected one, because of the monetary policy, which might consequently get tighter and of the limited trade spillovers. As a result, imposing an "aggregate fiscal stance" could be politically contested, and seen as not legitimate. The authors propose the creation of a joint budget to support stabilisation policies, financed with member States' contributions, focused only on addressing genuine cyclical risks. Nevertheless, such a solution might favour moral hazard, while reducing both the willingness to implement structural reforms and the high levels of public debt. Furthermore, a euro area fiscal framework should be transparent and responsive to euro area political preferences: the current framework seems not adequate and would require an institutional reform of the EMU.

F. Giavazzi *(Bocconi University, Milan)* argues in his paper that the concept of euro area fiscal stance has recently come to the forefront of the policy debate because the ECB reached the zero lower bound on interest rates, thereby curtailing its ability to use monetary policy to affect aggregate demand. The euro area fiscal stance could be therefore the relevant tool to offset cyclical fluctuations in output. The

author's analysis suggests that about one half of the savings that the euro area currently exports to the rest of the world (measured, at the end of 2015, by a current account surplus equivalent to 4% of the euro area GDP) could be spent (for consumption and/or investment) inside the euro area, in an attempt to move output and employment close to potential. However, difficulties arise from the fact that the euro area lacks instruments to control the euro area fiscal stance directly: in fact, the stance of fiscal policy can currently only be managed through individual actions at the level of individual Member States – and such actions run into the difficulties of fiscal policy coordination. As a possible solution, the author proposes a procedure whereby the Commission first decides the desired change in the euro area fiscal stance, and then the allocation of such a change among individual Member States, based upon their relative output gaps. Another proposal, which would require changes in the Treaty, envisages the creation of a fiscal capacity at the euro area level, through the transformation of the European Stability Mechanism in a new institution designed to play a central role in managing euro area domestic demand. The paper concludes by discussing some characteristics of the new institution, namely its governance, its resources (which would come from the issuance of "Stability Bonds"), the moral hazard concerns it may raise and its relationship with the European Commission and the European Fiscal Board.

Economic policy recommendations in the euro area under the European Semester

November 2015

In the paper by **K.J. Gern, N. Jannsen and S. Kooths** (*Kiel Institute for the World Economy*), the authors note that after three years of mixed operational experiences, the European Semester has been streamlined and further reform has recently been suggested by the European Commission. They 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. The authors 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, they develop proposals for improving the efficiency of the European Semester.

A. Bénassy-Quéré (*Paris School of Economics, University Paris 1 Panthéon-Sorbonne)* states in her paper that the European Semester is a well-intentioned attempt to foster macroeconomic policy coordination between Member states. However, the concept of euro area fiscal stance lacks operational instruments, the concept of macroeconomic imbalances is loosely defined, the Macroeconomic Imbalance Procedure (MIP) is weakened by its complexity, and its blurred frontier with respect to the Europe 2020 process further obscures the Semester. The euro area is still not well equipped to design a consistent macroeconomic policy and reduce the risk of long-lasting stagnation. The author proposes to use the future European Fiscal Board to promote an integrated view of fiscal policy, to make the MIP symmetric to the Stability and Growth Pact (SGP), with a flagship indicator (the current account) complemented with a limited number of indicators related to medium-term imbalances. Growth-enhancing policies would all fall under the Europe 2020 process ("integrated guidelines"), with alternating building blocks.

The paper by **F. Zuleeg** (*European Policy Centre*) assesses the economic policy coordination process in the euro area under the European Semester, and makes recommendations on how implementation could be enhanced and what further developments are necessary to improve coordination of economic policies within the EMU.

In their paper, **C. Alcidi** and **D. Gros** (*CEPS*) note that the implementation record of the Country Specific Recommendations has declined over time, as financial turbulences lessened and the economic outlook started to improve. Urgency for reforms seemingly receded to leave room to request from Member States towards more accommodative stances. It is mainly the small countries that implement, at least partially, the recommendations addressed to them. Unfortunately there is little that the EU can do to change the status quo. Yet, the President of the Eurogroup could be held accountable for the implementation of the recommendations addressed to the euro area. The creation of National Competitiveness Boards risks making the European Semester even more complex and likely to have little impact in the countries which need them most, namely large countries and those with poor governance. To make it effective, a procedure would be needed to make national wage norms consistent at the euro area level, which may be a very difficult objective to achieve.

Z. Darvas and **A.Leandro** *(Bruegel)* state in their paper that the Semester is a yearly process of the EU to improve economic policy coordination and ensure the implementation of the EU's economic rules. Each Semester concludes with recommendations for the euro area as a whole and for each EU member state. They show that implementation of recommendations was poor at the beginning of the Semester in 2011, and has deteriorated since. According to the authors, the European Semester is not particularly

effective at enforcing even the EU's fiscal and macroeconomic imbalance rules. They assess that euro area recommendations with tangible economic goals are not well reflected in the recommendations issued to Member States. Finally, they review various proposals to improve the efficiency of the European Semester and conclude that while certain steps could be helpful, policy coordination will likely continue to have major limitations.

Economic Governance Structures in the United States

October 2015

In his paper, J.F. Kirkegaard (*Peterson Institute for International Economics*) summarizes the history and organization of the principal economic governance institutions in the United States. Particular emphasis is given to the main U.S. fiscal actors at the federal and state and local governmental level. Sources and beneficiaries of, and trends in government revenues and expenditures are analyzed, and the lines of democratic oversight relations over other appointed U.S. economic governance institutions are described. Debt issuance procedures at all governmental levels are examined, including the legal circumstances of U.S. local government bankruptcies. In-depth explorations of also the U.S. central bank in the Federal Reserve System, and the U.S. bank deposit and resolution framework centered on the Federal Deposit Insurance Corporation (FDIC) are presented, and brief descriptions of other relevant U.S. financial regulatory agencies provided.

Debt sustainability and economic convergence of Euro Area Member States: Challenges and Solutions

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In his paper, **P. Mauro** (*Peterson Institute of International Economics*) argues that the Eurozone is at risk of economic stagnation and that the crisis has led to the most pervasive and pronounced increase in government debt-to-GDP ratios since the Second World War. Member countries are facing vastly differing economic growth rates, with some displaying hardly any recovery since the crisis began. His paper puts forward proposals aimed at fostering economic convergence, while ensuring debt sustainability for the Member States.

In the paper by **X.Ragot** (*Fondation Nationale des Sciences Politiques*), the author states that countries within the euro zone are facing three main perils: nominal divergences, materializing in unit labour cost differences; the lack of aggregate demand in Europe, the main issue in the short run; the high level of public debt, generating an issue of sustainability in some countries. The exclusive focus on both public debt and unit labour costs has produced a demand crunch in the euro area, which is the main cause of the deflation risk and high current account. The lack of demand is creating concerns about debt sustainability. A sustainable debt is not in fact a low or rapidly decreasing public debt, but one with no risk of default. The default risk in advanced countries is not an economic risk, but a political risk. High unemployment and a long-lasting recession are eroding political support for the European project, which can ultimately reduce countries' ability to generate a sufficiently high primary budget. All the flexibilities in the current treaty should be used to boost demand in Europe, without increasing the public debt burden of the heavily indebted countries. As some surplus countries, like Germany, decided not to use their fiscal space, one way to promote public demand is to design a public investment plan much bigger than the initial Juncker Plan and financed by funds backed by either national or European debt, which could be bought by the ECB. In addition, the European Semester should clearly start with an assessment of the aggregate fiscal and monetary stance in the euro area to provide the desired orientation for the European policy mix, consistent with country-specific recommendations.

C.Fuest (*IFO*) notes in his paper that several member countries of the Eurozone are plagued by increasing government debt and weak economic growth, raising concerns about fiscal sustainability. His paper discusses policy options to improve fiscal sustainability, focusing on two proposals: more public investment and growth oriented tax reforms. In recent years, a significant part of fiscal adjustment has been achieved by cutting public investment, rather than consumption spending. This suggests that there is potential for viable investment projects, but additional investment should be financed by restructuring public expenditure, not by additional public debt. Proposals to revise the Stability and Growth Pact by extending the room for debt financing of investment or to interpret the existing rules more 'flexibly' would undermine the credibility of the pact and question the commitment to fiscal sustainability. Tax policy can contribute to more growth by reducing taxes on corporate and labour incomes financed through higher taxes on consumption and higher recurrent taxes on immovable property. Various options for temporary tax changes would stimulate private consumption and investment spending in the short term.

The paper by **P.Manasse** argues that fiscal convergence in the Euro area has been achieved at the expenses of real divergence in unemployment, investment and, at least temporarily, growth. Statistical and econometric analysis supports the view that the current fiscal framework addressed debt sustainability concerns, but imparted a pro-cyclical bias, which contributed to economic divergence. The recent flexibility guidelines are a step in the right direction, but they are unlikely to have sizable effects. A reform of the fiscal framework and a mechanism for an intra-European unemployment insurance scheme is proposed.

Fiscal and macro-structural challenges and policy recommendations for the Euro Area and its Member States under the 2014 Semester Cycle

August 2014

The paper by **J.F.Kirkegaard** focuses on the need for euro area policy makers to sustain their recent crisis-induced reform eagerness to pull the region away from the threat of economic stagnation. Important policy challenges in ensuring that fiscal consolidation protects public investment spending, and in overhauling national bankruptcy procedures to facilitate private debt deleveraging and complementing the Banking Union is presented. The President of the Euro Group should be made a full-time position, and the post could have its democratic legitimacy enhanced through an expansion of the recent innovative *spitzenkandidat*-framework to also include it. This would require that the European Parliament created a new euro area-only institutional setting. Proposals to enhance the working of the Euro Group and its President are also presented.

P.Bofinger's paper states that the European Semester is an extremely important tool for economic policy coordination. In the absence of an integrated fiscal policy a monetary union requires a coordination mechanism to avoid negative spill-overs and to achieve an appropriate aggregate fiscal policy stance. In its present form, the focus of the Country Specific Recommendations (CSRs) is on the surveillance of fiscal policy consolidation and of structural reforms. A genuine coordination of national policies is virtually absent. There is also no systematic analysis of challenges for the main macroeconomic targets. The 2014 CSRs neglect the fact that target of price stability is not met and that there is a serious risk of deflation and economic stagnation. There is no systematic analysis whether the aggregate fiscal policy stance of the Euro Area is adequate. In the area of wage setting, the CSRs propose asymmetric wage reductions for many Member States which would increase deflationary tendencies. Therefore, the President of the Eurogroup should prepare a coordinated programme for public investments that could be implemented rapidly if the deflationary tendencies become manifest. In addition, (s)he should monitor wage relevant structural policies to avoid competitive (real) devaluations and encourage stronger wage increases in countries with a very high current account surplus.

D.Gros and C.Alcidi (*Centre for European Policy Studies*) note in their paper that most of the country-specific recommendations (CSRs) issued over the years 2011-13 concentrated on the need to reduce budget deficits “in a growth-friendly way” and to increase competitiveness. Both policy goals remain appropriate today. However, the CSRs have seldom indicated what concrete policy actions would make budget consolidation growth- friendly. The authors argue that the emphasis on boosting investment as a precondition for sustainable growth is misplaced and that fundamental reform of bankruptcy and insolvency procedures is needed to deal with the debt overhang in the euro area periphery. They also argue that the accountability of the President of the Eurogroup should be improved and that he/she should promote more collective action on common matters. Priorities for the next six months should focus on financial stability: completion of the banking union and dealing with the results of the asset quality reviews (AQRs).

This document provides the summaries of all external experts papers published during the eighth parliamentary term (2014-2019) by the Economic Governance Support Unit, aimed at supporting the scrutiny work on the functioning of the Euro Area, especially in view of Economic Dialogues with the President of the Eurogroup. This document was provided by the Economic Governance Support Unit for the celebration of the 20th anniversary of the euro.